BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Review of the Commission's Rules Regarding	)	
the Pricing of Unbundled Network Elements	)	WC Docket No. 03-173
and the Resale of Service by Incumbent Local	)	
Exchange Carriers	)	
	)	

INITIAL COMMENTS OF THE ILLINOIS COMMERCE COMMISSION

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I. INTRODUCTION AND SUMMARY

Pursuant to Rule 1.415 of the Commission's rules of practice and procedure, 47 C.F.R. § 1.415, the Illinois Commerce Commission ("ICC") hereby files its initial comments in response to the Notice of Proposed Rulemaking ("NPRM") released on September 15, 2003, in the above-captioned proceeding. Specifically, the Commission seeks comment on a comprehensive review of its current pricing rules for unbundled network elements (UNEs), adopted pursuant to section 252(d)(1) of the Communications Act of 1934 (the "Act"), as amended by the Telecommunications Act of 1996 (the "1996 Act"). The ICC supports the overall goals of the Commission regarding the need for reviewing and revising the Commission's rules for UNE pricing and submits the following comments.

The ICC regulates telecommunications services in the state of Illinois, and is responsible for approving tariff rates for retail and wholesale services. In carrying out those responsibilities the ICC has developed rules under state law that require

telecommunications carriers to provide tariffs before offering services. Those tariffs include wholesale discounts using the avoided cost guidelines as well as unbundled network element rates based on total element long run incremental costs (TELRIC) plus a reasonable amount of joint (Shared) and common costs. Earnings for UNEs are equal to the forward-looking cost of capital included as part of the TELRIC costs.

The ICC has gained valuable experience over the years in investigating and ruling on cases involving both wholesale discounts and UNE pricing. Throughout this time, the ICC has consistently promoted competition in Illinois through competitive wholesale and UNE rates. It is this experience that we draw upon in making our recommendations to the Commission in this proceeding. In particular, the ICC comments and generally states the following:

1. The ICC generally supports the Commission's efforts in updating the TELRIC methodology for developing UNE rates. However, we do not believe a drastic change in methodology is necessary at this time.
2. The ICC believes that forward-looking methodology should be used to determine long run incremental costs and therefore UNE pricing and that methodology could include some real-world attributes of the current network.
3. The *Triennial Review Order* will impact the inputs to TELRIC such as fill factors, cost of capital, and depreciation, plus network design and technology. However, we caution that changes made only to fill factors and depreciation rates greatly increased the potential rates charged by ILECs to CLECs in Illinois.
4. The ICC believes that non-recurring charges and joint and common cost allocations should not include costs that may be duplicated in retail rates. The rate structure for UNEs should be separate from the retail rate structure. That is,

there should be an allocation between retail and wholesale, not two separate structures. Rate deaveraging may need to be addressed because of UNE offerings being different when a portion of a rate zone is not "impaired." When a specific area within a rate zone is not impaired, that area must be removed from the average cost of that rate zone, and the remainder of the rate zone re-averaged to provide a new cost for the portion of the rate zone where impairment remains. Additionally, the frequency of UNE rate changes over time should be based on a specific time frame.

5. The ICC depends on models provided primarily by ILECs to determine costs, therefore transparency and verifiability are very important aspects of cost models and must be ensured.

6. The ICC provides our resale formula as a guide to the FCC on resale pricing**.** The formula demonstrates that Illinois has properly implemented the resale guidelines of using avoided costs rather than "avoidable costs" to determine the discount from retail rates.

7. The ICC is concerned with time frames for setting new UNE rates, and recommends that adequate time to all parties be provided when UNE rates are set under formal rate proceedings.

A more detailed list of our recommendations is set forth in section VII below. The ICC has limited the comments here to those issues that we believe are most important to promoting competition in Illinois. Silence on particular issues should not be interpreted as support for or disinterest in the Commission's comments and conclusions in those other areas.

The ICC believes that the experience and the results we have achieved in Illinois

by promoting the advent of competition through competitive wholesale and UNE rates have been generally positive. We urge the Commission to carefully consider our comments and recommendations before issuing its final rule in this proceeding.

II. BACKGROUND

State TELRIC Initiatives

The ICC has extensive experience in the implementation of forward-looking, cost-based wholesale rates. In its *Wholesale Order* – initiated before Congress enacted the Telecommunications Act of 1996 – the ICC established a cost based rate methodology to aid in setting wholesale rates for SBC to supply UNEs to competitors[1]. While the standards set by the ICC were not fully consistent with TELRIC – chiefly because the Commission had yet to issue its *First Report and Order* – the *Wholesale Order* nonetheless took steps that foreshadowed the FCC's policies, recognizing that, if effective competition were to emerge, UNE rates must be set so as to cause some competitive pressure on ILECs by requiring them to compete on the basis of price and quality[2].

Next, in its *TELRIC Order*, the ICC established TELRIC compliant rates for many SBC UNEs, finding that there should be a cost-based "bottom-up" approach to setting UNE rates[3]. It established unbundling obligations based upon its interpretation of the Commission's *First Report and Order* for, *inter alia*, shared transport, local switching and collocation, established either permanent or interim rates for those elements and

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[1] *See, generally, Order*, AT&T Communications of Illinois, Inc.: Petition for a total local exchange wholesale service tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company pursuant to Section 13-505.5 of the Illinois Public Utilities Act. LDDS Communications, Inc. d/b/a LDDS Metromedia Communications: Petition for a total wholesale network service tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company pursuant to Section 13-505.5 of the Illinois Public Utilities Act, ICC Docket No. 95-0458, 95-0531 (consol.), 1996 Ill. PUC LEXIS 320; 172 P.U.R.4th 434 (June 26, 1996) (hereafter "*Wholesale Order*").

[2] *Wholesale Order* at 39, *et seq*.

[3] *Second Interim Order*, Investigation into forward looking cost studies and rates of Ameritech Illinois for interconnection, network elements, transport and termination of traffic, ICC Docket Nos. 96-

0486 / 96-0569 (consol.) (February 17, 1998)(hereafter "*TELRIC Order*"), at 7.

services, and directed SBC to file compliance tariffs implementing the terms of the *Order*.

The ICC reviewed the SBC UNE tariffs for compliance in its *TELRIC II* proceeding[4]. In addition, in the orders issuing from the *TELRIC II* proceeding, the ICC set TELRIC-compliant rates for certain non-recurring charges. Contemporaneously, the ICC set TELRIC-compliant collocation rates for SBC's provisioning of collocation services[5].

Additional compliance matters were reviewed in the *TELRIC 2000* proceeding[6]. There, the ICC established TELRIC-compliant rates for SBC's provision of unbundled local switching and shared transport.

Finally, the ICC has, for some time, been engaged in a review of TELRIC issues associated with Verizon North, Inc. and Verizon South, Inc.'s (hereafter, collectively, "Verizon") provision of UNEs to requesting carriers. It has set TELRIC-compliant collocation rates for Verizon's provisioning of collocation services[7]. In addition, it has undertaken a review of Verizon's TELRIC methodologies and will thereafter review the

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4 *See, generally*, *Order*, Illinois Commerce Commission On Its Own Motion: Investigation into the compliance of Illinois Bell Telephone Company with the order in Docket 96-0486/0569 Consolidated regarding the filing of tariffs and the accompanying cost studies for interconnection, unbundled network elements and local transport and termination and regarding end to end bundling issues, ICC Docket No. 98-0396 (October 16, 2001) (hereafter "*TELRIC II Order*"); *Order on Reopening*, Investigation into the compliance of Illinois Bell Telephone Company with the order in Docket 96-0486/0569 Consolidated regarding the filing of tariffs and the accompanying cost studies for interconnection, unbundled network elements and local transport and termination and regarding end to end bundling issues, ICC Docket No. 98-0396 (April 30, 2002) (hereafter "*TELRIC II Order on Reopening*").

5 *Order*, Illinois Bell Telephone Company: Proposed Expansion of Collocation Tariffs, ICC Docket No. 99-0615, 2000 Ill. PUC LEXIS 657 (August 15, 2000); *Order on Rehearing*, Illinois Bell Telephone Company: Proposed Expansion of Collocation Tariffs, ICC Docket No. 99-0615, 2001 Ill. PUC LEXIS 63 (January 31, 2001).

6 *Order,* Illinois Commerce Commission On Its Own Motion v. Illinois Bell Telephone Company: investigation into Tariff Proceeding Providing unbundled Local Switching with Shared Transport, ICC Docket No. 00-0700 (July 12, 2002) (hereafter "*TELRIC 2000 Order*").

7 *Order*, Verizon North Inc. and Verizon South Inc.: Proposed establishment of collocation tariffs, ICC Docket Nos. 00-0511/0512 (consol.) (May 15, 2001); *Order on Rehearing*, Verizon Local Switching with Shared Transport, ICC Docket No. 00-0700 (July 12, 2002) (hereafter "*TELRIC 2000 Order*"). North Inc. and Verizon South Inc.: Proposed establishment of collocation tariffs, ICC Docket Nos. 00-0511/0512

company's UNE rates for TELRIC compliance[8].

(consol.) (November 29, 2001).

[8] *See, generally,* Verizon North Inc. (f/k/a GTE North Incorporated) and Verizon South Inc. (f/k/a GTE South Incorporated): Petition seeking approval of Cost Studies for Unbundled Network Elements, Avoided Costs, and Intrastate Switched Access Services, ICC Docket No. Docket No. 00-0812.

III. DISCUSSION

In the NPRM, the Commission systematically reviews numerous aspects of the current UNE pricing rules. Based upon our experience in Illinois, the ICC generally supports the Commission's efforts in updating the TELRIC methodology for developing UNE rates. However, we do not believe a drastic change in methodology is necessary at this time. In our comments, the ICC will address forward-looking methodology, in particular what factors should be used to determine long run incremental costs and therefore UNE pricing. The ICC will discuss how the *Triennial Review Order* will impact TELRIC, the inputs to TELRIC such as fill factors, cost of capital, and depreciation, plus network design and technology. The ICC will also comment on non-recurring charges, joint and common cost allocations, rate structure, rate deaveraging, and frequency of UNE rate changes over time. The ICC also notes that it does not develop its own cost models, but it depends on models provided primarily by ILECs to determine costs. Therefore, transparency and verifiability are very important aspects of cost models. Since the ICC first set wholesale pricing methods for SBC Illinois in 1996, we will provide insight into our resale pricing. The ICC will conclude its comments with a discussion of implementation issues, in particular the time frame for setting new rates, and conclude its comments with a general summary of its recommendations.

A. Forward Looking Methodology

In the NPRM, the Commission reaffirmed its commitment to forward-looking costing principles to determine UNE rates. It requests comment on whether clarifications or modifications should be made to the current forward-looking economic cost-based rules.[9]

The ICC believes that the prices of services provided by ILECs to CLECs ideally should be as close as possible to the prices that would exist under competition. As noted by the FCC in its *First Report and Order*, "in competitive markets, the price of a good or service will tend towards its long-run incremental cost. Forward-looking incremental costs, plus a portion of the forward-looking joint and common costs, are sometimes referred to as 'economic costs.'"[10] The challenge is in how to determine those costs. TELRIC is the approach recommended by the Commission and supported by the courts for estimating costs to be used in the pricing of unbundled network elements (UNEs). The FCC determined in its *First Report and Order* that the TELRIC approach is the most appropriate method for setting UNE prices[11].

This approach very closely mirrors the approach used in Illinois to determine forward-looking costs for retail services. It is the ICC's opinion that the TELRIC methodology should largely be retained. However, there may need to be some adjustments to the methodology so that the network assumptions being developed are more realistic, and less hypothetical. For example, the forward-looking network should be based on what will be built in the future when competition evolves, but should not be

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9 *NPRM*, ¶ 2.

10 [10] In the Matter of implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, CC Docket Nos. 96-98 and 95-185, FCC No. 96-325, 11 FCC Rcd 15499 (released August 8, 1996) (hereafter "*First Report and Order*"), ¶675.

a totally hypothetical network that will never be built. As discussed later in more detail, this means that the CLEC should not have to pay for UNEs based on technology the ILEC cannot provide, but should be required to pay for UNEs provided by the ILEC, even if the CLEC does not use all of the capabilities of the UNE.

The ICC also believes that TELRIC should be retained in some manner so that there remains a consistency in the rules going forward. This consistency is important so that competitors continue to have knowledge of what it will cost to enter the market, and how much revenue they will need to generate in order to remain in the market long-term and advance from using the UNE Platform to a system that relies more on utilization of their own facilities. The ICC believes that maintaining some certainty in pricing methodology is required in order to cultivate competitive markets in the future.

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[11] *See, generally*, *First Report and Order*.

B. UNE Pricing

1. Overarching Issues

a. Goals of UNE Pricing

The Commission requests comment on its current UNE pricing objectives[12]. In particular, the Commission solicits comment upon whether the primary goals of UNE pricing should remain: 1) sending efficient entry and investment signals to all competitors; and, 2) providing incumbent LECs an opportunity to recover the forward looking costs of providing UNEs[13].

The ICC concurs with both of the Commission's pricing goals. A primary goal of UNE pricing should be to set efficient entry and investment signals. UNE prices that are set above forward-looking costs will result in inefficient entry and unnecessary duplication of facilities. If UNE prices are set well in excess of forward-looking costs, competitors may be induced to build their own facilities to avoid paying excessively high UNE rates, even if their costs of building new facilities are higher than the ILEC's cost of building new facilities.

On the other hand, UNE prices that are set below forward-looking costs will discourage efficient facilities-based entry. UNE prices that are too low will deter efficient competitors from building new facilities because these efficient competitors will prefer to lease facilities priced below cost rather than risk building their own facilities.

The ICC believes that in order to deter inefficient entry and encourage efficient facilities-based entry, UNE prices should be set at levels that are consistent with forward-looking costs, since in competitive markets prices tend to reflect forward-looking costs.

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12 *NPRM*, ¶4

13 *Id.,* ¶5

UNE prices based on historical costs may lead to inefficient facilities-based entry, or discourage efficient facilities-based entry.

Moreover, drastic changes in the Commission's pricing rules at this time may be disruptive to the marketplace. Competitors, both existing and potential, may be uncertain about how to interpret new pricing rules, and what these new pricing rules will mean for the UNE rates they are currently paying. Changing pricing rules could lead to court challenges of these new rules that would heighten the uncertainty and further unsettle the marketplace.

The Commission also requests comment on how it could measure empirically whether any particular set of UNE prices is sending the appropriate signals with respect to competitive entry and investment[14]. The ICC sees no obvious criteria that can be used to mechanistically judge whether any particular set of UNE rates is sending out the right price signals. However, the ICC notes that there are several criteria that are clearly not useful. Specifically, the ICC cautions the Commission against evaluating the appropriateness of UNE rates by looking at the percentage of competitor-provisioned access lines served by facilities-based entrants. Assume, for example, both an ILEC and a CLEC would incur identical costs for building facilities in a particular area. Thus, under optimally priced UNE rates, the CLEC will be indifferent to whether it builds its own facilities, or leases facilities from the ILEC. Under these circumstances, therefore, it is possible that all entrants will be facilities-based, no entrant will be facilities-based, or where some of the entrants will be facilities-based, and others will not. All these possible outcomes are consistent with optimally priced UNE rates. Consequently, looking at the

[14] *Id*.

percent of competitive lines that are served by facilities-based entrants is not an empirical criterion that should be used to judge the appropriateness of UNE rates.

In addition, the Commission seeks comments on whether it is appropriate to judge the reasonableness of UNE rates by comparing these rates to the ILEC's historical costs[15]. The ICC has fundamental reservations about using historical costs to judge the reasonableness of forward-looking costs, since historical costs were incurred through the purchase of past technologies and network designs rather than forward-looking technologies and designs. Moreover, historical costs may reflect past inefficiencies – the greater these past inefficiencies, the greater the likely difference between historical costs and forward-looking costs. The ICC believes that the Commission should develop more detailed guidelines for forward-looking cost studies that states can use for the states' UNE rate setting proceedings.

It should be noted that UNE tariff rates were initially set for Illinois Bell Telephone Company in litigated proceedings where all parties were able to explore the issues and look at the costs detailed by the ILEC[16]. UNE rates developed using such a process should provide for full recovery of forward-looking economic costs to the ILEC. In the ICC's various TELRIC proceedings, however, some of the costs filed as forward-looking by the ILEC were the subject of debate, and the ICC ultimately set the rates below those initially proposed by the ILEC[17].

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15 *Id*. ¶40

16 *See, e.g.*, *Second Interim Order*, Investigation into forward looking cost studies and rates of Ameritech Illinois for interconnection, network elements, transport and termination of traffic, ICC Docket Nos. 96-0486 / 96-0569 (consol.) (February 17, 1998)(hereafter "*TELRIC Order*")

17 *See, generally, e.g.*, *TELRIC Order*; *Order*, Illinois Commerce Commission On Its Own Motion: Investigation into the compliance of Illinois Bell Telephone Company with the order in Docket 96-0486/0569 Consolidated regarding the filing of tariffs and the accompanying cost studies for interconnection, unbundled network elements and local transport and termination and regarding end to end bundling issues, ICC Docket No. 98-0396 (October 16, 2001) (hereafter "*TELRIC II Order*")

It is difficult to determine whether historical costs were incurred to build an efficient forward-looking network. However, the ICC believes that if the incumbent's historical network is not efficient on a forward-looking basis, the ILEC should not necessarily be allowed to recover its embedded costs from CLECs through its UNE rates. In addition, if the retail price for a service was not set to recover the full costs of the service due to a rate design established under rate of return regulation, it is possible that the retail rate structure should be revised to fully recover those costs. The inconsistency between retail and UNE rates demonstrates the fundamental inconsistency between the design of a competitive network, and the design of a network completed under rate of return regulation. Under rate of return, where the ILEC was able to recover all of its costs, plus a reasonable return on its rate base, there was little incentive for the ILEC to design a "most efficient" network. ILECs under rate of return did not have to consider or plan for competition; they only had to be concerned with whether the network would provide quality service to their current and potential customers. This factor may have caused ILECs to overbuild their networks, since there was no competition, and hence no incentive to cut costs, because assured recovery of a fixed rate of return on rate base provided an incentive to increase the rate base through investments. With the advent of competition, the network must be designed more efficiently, and with TELRIC pricing, the ILEC is only allowed to recover the costs of that more-efficient network.

b. Impact of Triennial Review

The Commission seeks comments regarding the relationship between the recent *Triennial Review Order* ("TRO")[18] and the Commission's UNE pricing rules[19]. The ICC believes that if a CLEC is not entitled to features, functions and capabilities of a UNE, based on the new FCC interpretation of Section 251(d)(2)[20], the CLEC community should not be compelled to absorb any of the costs for those features, functions and capabilities. If a CLEC has no entitlement to the features, functions and capabilities of a UNE, then fairness requires that the full cost recovery for those features, functions and capabilities should be placed on the ILEC. This should apply whether the cost is for a direct expense and investment, or an allocation of overhead (shared and common) costs.

More specifically, the Commission seeks comment regarding the implications on forward-looking pricing methodology that arise as a result of limitations on UNE use imposed by the Commission in the *Triennial Review Order*[21]. As explained below, examining the implications of limitations on UNE use reveal shortcomings with the Commission's existing TELRIC methodology that predate the *Triennial Review Order* and that are inherent in the Commission's existing TELRIC methodology.

The Commission states: "Previously, UNEs were, with limited exceptions, not defined with regard to technology." [22] As a pragmatic matter this statement is inconsistent with the manner in which the Commission's current prescribed forward-looking pricing methodology must, by necessity, be implemented in all states.

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18 *Report and Order and Order on Remand and Further Notice of Proposed Rulemaking*, In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, and Deployment of Wireline Services Offering Advanced Telecommunications Capability, CC Docket Nos. 01-338, 96-98 & 98-147, FCC 03-36 (rel. Aug. 21, 2003) ("*Triennial Review Order*" or "TRO").

19 *NPRM*, ¶42

20 *See*, generally, *Triennial Review Order*.

21 *NPRM*, ¶¶ 43-44; *see also Triennial Review Order.*

In its *First Report and Order*, the Commission noted that "Section 3(29) of the Communications Act defines the term 'network element' to mean both 'a facility or equipment used in the provision of a telecommunications service' and 'features, functions, and capabilities that are provided by means of such facility or equipment[23].'" This is consistent with the fact that different facility or equipment technologies provide different features, functions, and capabilities. For example, a local loop that is provided over copper technology often differs in features, functions, and capabilities from a local loop provided over fiber facilities. Therefore, in practice, two different technologies used to provide local loops generate two different variations of the unbundled local loop. This creates a practical problem for states in setting prices based on existing TELRIC rules.

The Commission's existing TELRIC rules require that "costs must be based on the incumbent LEC's existing wire center locations and most efficient technology available[24]." However, as noted above, differing technologies provide for differing features, functions, and capabilities. It is often the case that state commissions are presented with cost information on technologies that have the potential to more efficiently provide features, functions, and capabilities inherent in existing ILEC network elements,

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22 *NPRM*, ¶ 43

23 *First Report and Order*, ¶ 249.

24 *First Report and Order*, ¶ 690.

but that provide for additional features, functions, and capabilities not found in the existing ILEC network elements.[25] If state commissions elect to consider basing TELRIC prices on the costs associated with these alternative technologies, then the state commissions must determine whether to allow recovery for the entire cost of the more efficient technology, or to allow recovery for only those costs of the new technology that are associated with features, functions, and capabilities that mirror those found in the ILEC's existing network elements.

Allowing the recovery of the entire cost of the more efficient technology best comports with the Commission's original TELRIC pricing methodology. For example, in the *First Report and Order*, the Commission stated that its TELRIC methodology was adopted because "TELRIC-based pricing of discrete network elements or facilities, such as local loops and switching, is likely to be much more economically rational than TSLRIC-based pricing of conventional services, such as interstate access service and local residential or business exchange service[26]." The Commission reached this conclusion based on the notion that:

> [T]he network elements, as [the Commission] defined them, largely correspond to distinct network facilities. Therefore, the amount of joint and common costs that must be allocated among separate offerings is likely to be much smaller using a TELRIC methodology rather than a TSLRIC approach that measures the costs of conventional services. Because it is difficult for regulators to determine an economically-optimal allocation of any such joint and common costs, [the

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[25] For example, in the Commission's *Verizon Pennsylvania Order*, the Commission noted that "[i]n the MFS III Order, the Pennsylvania Commission made a decision to use Next Generation Digital Loop Carriers rather than existing Digital Loop Carriers." *Memorandum Opinion and Order*, ¶57, Application of Verizon Pennsylvania Inc., Verizon Long Distance, Verizon Enterprise Solutions, Verizon Global Networks Inc., and Verizon Select Services Inc. for Authorization To Provide In-Region, InterLATA Services in Pennsylvania, CC Docket No. 01-138, 16 FCC Record 17419, 17421 (released September 19, 2001) (hereafter "Verizon Pennsylvania Order"). As the Commission has recognized, Next Generation Digital Loop Carrier systems provide features, like the ability to provide broadband services, not found in their predecessors. *See* TRO, ¶218, n. 669. Despite the differences in features the Commission accepted Verizon's choice to model NGDLCs rather than existing DLCs relying on the Pennsylvania Commission's finding that this choice was likely to yield lower costs (presumably for the loop features, functions, and capabilities that Verizon was, in fact, providing at the time). Verizon Pennsylvania Order, ¶59.

[26] *First Report and Order*, ¶ 678.

> Commission's stated belief was] that pricing elements, defined as facilities with associated features and functions, is more reliable from the standpoint of economic efficiency than pricing services that use shared network facilities[27].

Allowing the recovery of the entire cost of the more efficient technology, will, in many circumstances, permit ILECs to recover costs of features, functions, and capabilities that exist in the more efficient technology being priced, but that do not exist in the technology that is being provided. In such instances, CLECs purchasing UNEs will pay for features, functions, and capabilities they do not receive and cannot obtain. Allowing recovery for only those costs of the new technology that are associated with features, functions, and capabilities that mirror those found in the ILEC's existing network elements resolves this problem; that is, it does not require CLECs to pay for features, functions, and capabilities that they can not receive. However, allowing recovery for only those costs of the new technology that are associated with features, functions, and capabilities that mirror those found in the ILEC's existing network creates the very problems that the FCC's TELRIC methodology was developed to address.

If states allow recovery for only those costs of the new technology that are associated with features, functions, and capabilities that mirror those found in the ILEC's existing technology, then the states must determine how to allocate costs between features, functions, and capabilities that mirror those found in the ILEC's existing technology and those that do not mirror them. Invariably, this exercise requires the state commissions to make joint and common cost allocation decisions. As explained above, the primary advantage of TELRIC methodology over TSLRIC methodology is that TELRIC is designed to estimate the cost of an entire element including all its features, functions and capabilities while TSLRIC is designed to allocate costs between services

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[27] *First Report and Order*, ¶ 678.

that share a network element and its features, functions and capabilities. Thus, if states allow recovery for only costs of the new technology that is associated with features, functions and capabilities that mirror those found in the ILEC's existing territory, then the states must, in effect, use TSLRIC methodology. Therefore, from the standpoint of economic efficiency, the benefits promised by TELRIC in theory will not be realized in practice. From a practical stand point the Commission's existing TELRIC rules, if used to develop costs for a portion of a UNE's features, functions and capabilities, suffer the same deficiencies related to allocation of joint and common costs as those associated with application of TSLRIC methodology. In soliciting input on the effect of the *Triennial Review Order*, the Commission asks: "What adjustments, if any, should states make to recognize this more limited availability of UNE loops?"[28] As noted above, in implementing current TELRIC rules, states already face the prospect of making TSLRIC adjustments to costs in order to recognize differences in features, functions, and capabilities. Thus, the limitations imposed by the Commission in the *Triennial Review Order* do not raise new considerations, but rather draw attention to existing concerns with which states have been forced to grapple in implementing current TELRIC rules.

The ICC recommends that, if the Commission decides to retain forward looking pricing methodology, it clarify that forward-looking UNE rates are to recover only those forward-looking costs associated with providing features, functions, and capabilities that the ILEC is providing through its existing network elements and that recovery shall not include costs associated with providing features, functions, and

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28 *NPRM*, ¶ 43.

capabilities that the ILEC does not provide through its existing UNEs.

Additionally, the ICC recommends that the Commission permit recovery for all features, functions, and capabilities that the ILEC currently provides to the CLEC over the ILEC's existing technology, whether or not the CLEC takes advantage of all such features, functions, or capabilities offered. Consistent with our recommendation above, the ICC recommends that the FCC clarify that UNEs are defined by the features, functions and capabilities that the ILEC currently provides. Just as the cost of the UNE should not include costs of features, functions and capabilities that the UNE, when provisioned by the ILEC, in reality does not possess, it should include the costs of features, functions and capabilities that when provisioned by the ILEC, in reality it does possess.

Thus, the Commission should clarify that the UNEs provided by an ILEC are defined by the features, functions, and capabilities actually being provided by the ILEC. This will further clarify that forward-looking costs are not costs of providing UNEs with different features, functions, and capabilities, but rather are costs of providing the existing features, functions, and capabilities using the most efficient and cost effective technology currently available.

Regarding any specific limitations imposed by federal or state regulation and, in particular, by the *Triennial Review Order*, the ICC recommends that ILECs be permitted to recover only those costs associated with features, functions, and capabilities that they actually offer to CLECs through their network elements. While this recommendation could potentially create a cost difference for CLECs and ILECs, the ICC believes such a difference is appropriate, given the imposed limitations. As stated above, a CLEC that elects not to provide certain features, functions, and capabilities should not be able to

avoid the costs of those features, functions and capabilities. However, when the ILEC takes advantage of its legal rights to impose usage limitations, the CLEC is not avoiding the use and cost of additional features, functions and capabilities by its own choice. In those instances where the ILEC chooses to prevent CLECs from accessing certain features, functions, and capabilities, the ILEC should assume the costs of those features, functions, and capabilities. So long as certain features, functions and capabilities associated with UNEs are unavailable to CLECs, the development of TELRIC-based UNE prices will continue to require state commissions to develop UNE prices based on the services actually being provided rather than on the full array of services that would, absent discretionary limitations, be available via the UNE. The ICC also notes that the recommendations it makes here, while not departing from forward-looking cost principles, may, depending on how states have implemented existing TELRIC rules in the past, represent a movement toward evaluation based on the ILEC's existing technology and, in particular, the features, functions and capabilities of the existing technology. This will ensure that CLECs do not pay for features, functions and capabilities that they cannot access, and that ILECs recover the forward-looking costs associated with the features, functions, and capabilities they provide.

The Commission seeks comment regarding how costs are to be developed when UNEs are no longer required to be provided throughout an ILEC's service territory as may be the case in light of the Commission's *Triennial Review Order*[29].

[29] *NPRM*, ¶¶ 43, 44.

As explained below, one new issue that arises from the fact that UNEs may be removed on a market-by-market basis relates to implementation of rate changes over time.

Under current TELRIC rules it has been the standard practice to create UNE prices based on the averaging of forward-looking costs associated with multiple geographic areas. For example, in Illinois there are three SBC UNE rate zones. UNE rates are uniform within each zone, but differ across zones. While UNE rates within each zone do not vary, cost characteristics within each zone will differ. For example, loop costs are driven in part by customer and wire center locations and therefore may vary by wire center and even by customer[30]. Pragmatic considerations have required and will continue to require some degree of averaging across areas. Thus, despite the fact that UNE rate zones are generally selected on the basis of common cost characteristics, cost variations remain within these zones.

In the past, a particular network element either was or was not provided as a UNE within a zone.[31] This discreet dichotomy allowed for the practice of creating UNE prices based on the averaging of forward-looking costs associated with multiple geographic areas (e.g., averaging across multiple wire centers). Illinois is currently in the early stages of implementing the *Triennial Review Order.* These proceedings might reverse national impairment findings for some UNEs in portions of existing UNE zones. Should the ICC not reverse such findings within its initial proceeding, it might do so in future UNE impairment proceedings, within the guidelines provided in the *Triennial Review*

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[30] In reality, because loop costs vary according to customer and wire center location, each individual loop is likely to cost a different amount than any other to provision.

[31] The ICC notes that the *UNE Remand Order* contemplated removal in the past of the switching UNE in the Chicago MSA under certain circumstances, which would have resulted in removal of a UNE in portions of certain UNE zones. *Third Report and Order and Fourth Further Notice of Proposed Rulemaking*, ¶¶280-81, 284, 288, 468, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, FCC 99-238 (Nov. 5, 1999) (hereafter "*UNE Remand Order"*). However, such removal was not effectuated in the past in Illinois and, therefore, the

Order.[32] If ILECs are no longer required to provide a UNE in a portion of a UNE zone then average costs across the zone will no longer reflect average costs across the portion of the UNE zone for which UNEs must be provided by the ILEC. For example, suppose an average cost for a UNE zone is comprised of the average costs of providing the UNE in seven (7) wire centers within that zone. If an ILEC is relieved of its unbundling obligations and discontinues provision of UNEs in one (1) of the seven (7) wire centers in that zone then the pre-existing average UNE cost for the UNE zone will reflect the average of the costs of providing UNEs in the seven (7) wire centers, not the six (6) wire centers where the ILEC will continue to provision UNEs. Thus, the average UNE cost in the zone will, if unadjusted, continue to reflect the costs of providing UNEs in an area where the ILEC does not provide them. Therefore, as a practical matter, when ILECs are no longer required to provide UNEs in a portion of a UNE zone, the UNE rates will no longer be reflective of the costs of providing UNEs in remaining portions of UNE zones.

The ICC recommends that the FCC take these considerations into account when and if it develops guidelines that pertain to rate changes over time.[33] Any guidelines established by the FCC should address how updating is to occur as UNEs are removed from portions of UNE zones. In particular, the ICC recommends that the Commission determine that TELRIC compliance requires the ILEC, when establishing UNE rates for any particular area, to ensure that such rates are based upon the forward-looking costs of providing the UNEs in that area alone. This will require ILECs to revise UNE rates whenever the ILEC discontinues UNE provisioning in some portion of a UNE rate zone.

The ICC acknowledges that updating UNE rates is an expensive, time-consuming,

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ICC did not any implementation issues associated with selected geographic removal of UNEs in practice.

[32] For example, see *Triennial Review Order* at ¶418.

[33] See Section III(J).

and complicated process. However, ILECs and other interested parties may benefit from knowing in advance that averages developed for UNE zones may need to be deaveraged to remove cost information related to areas where UNEs no longer are offered and then reaveraged based on the new, alternative (presumably smaller) geographical area. This will enable parties to evaluate cost estimates, particularly those that are likely to be developed based on the Commission's revised rules in this proceeding, keeping an eye on details that may not be of primary importance in initial rate development, but that will be of primary importance as rates are amended in response to changing UNE obligations over time.

c. Joint (Shared) and Common Costs

The Commission also requests comment regarding the allocation of overhead and other common costs[34]. The ICC recommends that overhead expenses be limited to those that relate only to the UNE, or wholesale, part of the business. The shared and common costs added to TELRIC for UNEs should be related exclusively to the care of the wholesale customer rather than the retail customer. In other words, if a common cost of the organization supports both the retail and wholesale sides of the business, part of that cost would be allocated to the retail business and part to wholesale. The entire cost should not be applied to both retail and wholesale services.

The ICC notes that the current rules are sufficient, although somewhat imprecise, regarding the recovery of shared and common costs through recurring UNE rates. The existing rules regarding recovery of shared and common expenses would benefit from explicit language, perhaps examples, that delineate, for instance:

- that anything attributable to retail activities is not recoverable from UNE rates;
- that marketing expenses for the ILEC's brand or name recognition is not recoverable from UNE rates;
- that regulatory fines and other compliance costs are not recoverable from UNE rates.

The ICC suggests that such rules regarding the allocation of common, or, for preference, shared and common costs, be explicit, as such costs can become a large driver of UNE rates. Administrative rules promulgated by the ICC dictate that when costs can be directly assigned, they should be[35]. If shared and common costs cannot be directly assigned, they should be allocated based on a ratio of related retail expense to the related wholesale expense[36]. In its *TELRIC Order*, the ICC allowed shared and common cost

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34 *NPRM*, ¶113

35 83 Ill. Admin. Code §§791.30, 791.40

36 *Id.*

allocations to both recurring and non-recurring charges, but only allowed recovery from wholesale customers through UNEs of those costs applicable to the wholesale part of the business[37]. Further, some adjustments should be considered for non-recurring costs and charges, as these costs relate to wages and salaries that tend to increase over time. These increasing costs could be somewhat offset by some type of efficiency or productivity factor so that the entire forward-looking increased labor costs do not have to be recovered from CLECs. The ICC offers more extensive comment regarding non-recurring charges in a later section.

The Commission's rules on shared and common costs, with its emphasis on "reasonable recovery," is an excellent place for the Commission to clearly differentiate shared wholesale costs from other types of shared costs. A crucial test for shared UNE costs can be set forth as follows: if the UNE provision activities ceased, that set of costs would disappear.

In particular, the ICC recommends that the existing rules could be enhanced by expressly prohibiting any cost models that identify a "wholesale" or "retail" network that is purportedly separate from the ILEC's entire network. Aside from being theoretically invalid[38], such models can too easily overlook the separation and appropriate identification of shared retail costs from shared UNE costs, or over-estimate common costs by loading the same administrative costs onto two separate network models.

In the NPRM, the Commission suggests that the goals of transparency and verifiability, informed by their experience in the universal service context, are two meaningful goals for state commissions and their ability to "determine UNE costs in a

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[37] *TELRIC Order* at 92 *et seq*.

[38] According to regulatory economic theory, the only network that exists is the entire network. There exists no separate "wholesale" or "retail" network whose costs can be estimated separately from the

reasonable time frame."[39] These goals are especially relevant to the estimation of shared and common costs, whether such costs are calculated within a particular cost model or separate from a cost modeling exercise. For estimating shared and common costs for UNE rates, transparency is taken to mean that the estimation of these costs is well documented, and can be readily audited. Transparency also suggests that a Commission or intervenor can readily review how an estimate is constructed. This goal is important, as cost models are presumably fallible[40]. Commissions must be able to audit expenses as submitted, to determine the extent to which items are shared UNE costs or common costs, and cannot be attributed to the ILEC's retail operations. Likewise, for the setting of UNE rates, forward-looking adjustments need to be properly identified, fully documented and supported in testimony.

The ICC recommends that the existing guidelines regarding the recovery of shared and common costs be maintained. The guidelines would only be enhanced through the addition of more specific guidelines and examples as demonstrated above.

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entire network.

[39] *NPRM* , ¶41

[40] Recent experience with cost models in Illinois, for example, led to the discovery of inadvertent errors on the part of the ILEC during the review process, and to the filing of revised data.

2. Relationship to Universal Service

The Commission seeks comments regarding the relevance of statements it made in the universal service context for specific UNE pricing rules.[41] The Commission has made it clear in various orders, including the NPRM, that it had not intended for its USF inputs to be used for the purpose of UNE rate making.[42] Because the FCC has been emphatic on this issue, the ICC has been careful not to rely on any federal USF proceeding for guidance in regard to UNE rate development.

The ICC has limited experience with federal USF proceedings. Therefore, the ICC does not take a position on specific assumptions and inputs used in USF cost development. The ICC understands that USF inputs were developed on a national basis and for purposes that are distinctly different than for UNE rate development. The ICC recognizes that costs differ significantly from state to state and believes that it is uniquely qualified to determine the appropriate UNE rates for Illinois markets.

The cost model adopted by the FCC in its *Universal Service Order* is a generic model that is not specific to companies operating in Illinois. The ICC depends on cost models specific to each ILEC to determine UNE costs for that ILEC. It is the ICC's belief that company-specific models provide more reasonable costs for pricing UNEs. However, if the Commission decides to change the cost parameters for determining UNEs to reflect the wire center costing in its Universal Service cost model, the ICC would consider making that change as we consider other changes to the company-specific models now used by SBC, Verizon and other ILECs.

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41 *NPRM* , ¶48.

42 *See, e.g., Fifth Report and Order*, ¶9, In the Matter of Federal-State Joint Board on Universal Service / Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, FCC No. 98-279, CC Docket Nos. 96-45, 97-160 (October 22, 1998: Adopted; October 28, 1998: Released); and *Tenth Report and Order*, ¶30, In the Matter of Federal-State Joint Board on Universal Service / Forward-Looking

Mechanism for High Cost Support for Non-Rural LECs, FCC No. 99-304, CC Docket Nos. 96-45, 97-160 (October 21, 1999: Adopted; November 2, 1999: Released).

C. Network Assumptions

1. General Theory

a. Network Design Assumptions

The FCC seeks comment regarding network design assumptions to be used in developing forward-looking costs[43]. As a practical matter, the ICC has found the existing rules, which allow for a network design that incorporates existing wire centers and existing customer locations, to be a reasonable standard, and one which reduces litigation of network design issues in proceedings for determining UNE rates. Any revision of this current standard should likewise introduce clarity into state proceedings.

The Commission tentatively concludes that TELRIC rules should more closely account for the real-world attributes of the routing and topography of an ILEC's network and seeks comment on how such an approach may differ from the practices of state commissions in UNE pricing proceedings.[44] In Illinois, the ICC has followed the guidelines of the *First Report and Order* in determining the layout of the ILEC's network, especially when it comes to the design and replication of the local loop, or "last mile" connecting the central office to the end user. It is the ICC's belief that routing and topography should be a factor when determining the costs of feeder and distribution investment to be used by ILECs to reach end user customers. The ICC also believes that these attributes would have greater impact on mass-market customers outside enterprise areas since much of the investment in enterprise areas has already been replicated and CLECs tend to make larger investments in enterprise markets than in outlying market areas.

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43 *See, e.g.,* NPRM, ¶¶ 43, 44, 51, 52

44 *Id.*, ¶ 52

Further, the ICC notes that the Commission's statements regarding the incorporation of currently available, forward-looking technologies[45] align well with the ICC's current administrative rules[46]. On the other hand, however, if this approach is adopted, there must be steps taken to make sure that costs of embedded investment are not combined with forward-looking costs in a way that artificially increases the TELRIC, and therefore the UNE rate. For an efficient forward-looking network, regulators must be careful not to rely on embedded network technology that might not be efficient in today's world. Regulators must also be careful not to base costs on a network designed to provision services that the carrier has no intention of offering. The ICC is concerned about a forward-looking network design that has no basis in reality. As such, the ICC recommends that the Commission clarify in its rules that forward-looking technology be modeled only to the extent that it provides a least-cost means of provisioning services.

How carriers are allowed to recover planned network upgrades is another important consideration. To this end, the Commission seeks comment on whether the relevant network should be defined as one that incorporates planned upgrades by the ILEC[47]. As engineering plans are subject to change based on financial considerations, demand, or other influences, our opinion is that those plans cannot be depended upon in the short term, let alone over the life of a 3-5 year planning cycle. Accordingly, if a specific planning cycle is used to determine UNE rates, it is possible for the ILEC to use that plan to project ambitious upgrades that will increase the UNE rates, and then scale down the plans in practice. Further, to the extent that such upgrades are planned, they must be tied directly to the provisioning of services that the carrier plans to offer over the

45 *Id.*, ¶ 53
46 83 Ill. Admin. Code §791.10 *et seq*.
47 *NPRM*, ¶ 53, 54.

period in question. The ICC is concerned that carriers will justify increased investment in state of the art technology in the modeled network for the provisioning of data services with ever increasing data speeds, where there is no evidence to suggest that the CLECs will have access to such services. Without clear-cut guidelines, carriers and state commissions alike will suffer from confusion regarding the Commission's position on the propriety of hypothetical network designs.

The Commission seeks comment on shifting from a long-range average cost methodology to a short-range methodology[48]. As the ICC has been able to set UNE rates using the methodology originally proposed in the FCC's *First Report and Order*, it is its belief that the long run costs (at least a 3 to 5 year projection) provide a more reasonable reflection of the efficient network than using embedded costs or short-run costs (1 to 2 years) would provide. The ICC, therefore, recommends that the current long-range UNE methodology represents the most reasonable approach[49]. It preserves logical consistency by minimizing embedded costs, maintains consistency with current UNE rates, and gives both ILECs and CLECs direction for their respective planning cycles.

The Commission further asks if there is a reason to depart from current pricing rules that provide that competitive LECs should not pay UNE rates that compensate incumbent LECs for past inefficiencies[50]. The ICC does not believe there is any reason to depart from this principle, nor does it believe the Commission should assume that an ILEC's practices are efficient. Most ILEC facilities were placed when the telecommunications industry was a regulated monopoly, and placement of an efficient network was not necessarily a primary objective. Presuming that an ILEC's network is

48 *Id.*, ¶ 55.
49 *Id.*, ¶ 56.
50 *Id.*, ¶ 58

efficient will probably tend to increase UNE rates. For example, high fill factors would exist in an efficient network, while a fill factor of less than 50% would indicate that the network was not designed for efficiency.

The ICC notes that changing network assumptions by using actual fill factors and accelerated depreciation will probably lead to higher UNE rates[51]. The ICC observes that, when legislative action in Illinois directed it to set UNE rates based on actual fill as provided by an ILEC as well as the use of accelerated depreciation the company used in its financial reporting, these changes caused a considerable increase in UNE rates as shown in the table under Fill Factors in Section III(C)(2)(d).

The Commission asks if a regime focused more closely on the existing network of an ILEC would be easier for state commissions to implement than the current TELRIC regime[52]. The ICC believes that the answer is yes. Costs of the existing network are indeed more easily verified than the forward-looking costs of an economically efficient network. However, the ICC has used the scorched node concept in setting current UNE rates. It has also undertaken extensive litigation of the inputs and methodology used by the ILECs. It therefore believes that it would be a greater burden to state regulators to change the game plan for the UNE rate-making process after following the original plan for more than six years. With a change in methodology at this time, every state commission will be forced to start fresh in its interpretation of the federal rules.

The Commission also seeks comment on whether focusing the cost inquiry on an incumbent's existing network might place CLECs at an informational disadvantage in litigating factual issues about which the ILEC may have better information.[53] The ICC

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51 *Id*., ¶ 59
52 *Id*., ¶ 60
53 *Id*., ¶61

believes that the ILECs will always have the advantage over CLECs and state commissions assessing their real network costs because ILECs control all the data, and provide that data to other parties for analysis only when required. The ILECs will always be in the best position to determine their own costs, whether embedded, forward looking projections of embedded, or forward looking based on a hypothetical, most-efficient network using the best technology currently available. Because the ILECs control all the information, identification of objective sources of input by the Commission for calculating TELRIC rates would be helpful.[54]

In the NPRM, the Commission seeks comment on ways in which UNE pricing proceedings can be streamlined.[55] The ICC recommends that this process preserve adequate safeguards to ensure that regulators have appropriate access to necessary information and sufficient time for review and analysis. In particular, the ICC recommends that the FCC adopt filing requirements and be flexible in placing time constraints on UNE proceedings.

The ratemaking process is complex and lengthy. Illinois regulators must review an extraordinary volume of data that is provided in support of proposed UNE rates. The ILECs are in control of all the data, and extensive discovery is needed for state commissions and other parties to obtain the needed data and perform detailed analyses. The Illinois Public Utilities Act[56] requires that tariff investigations, whether the tariff is retail or wholesale, be completed within eleven (11) months for investigation of a tariff that is suspended[57]. For initial investigation of a UNE filing, where tariffs have not been filed, the investigation may take even longer so that all parties can conduct adequate

54 *Id*.
55 *Id*., ¶ 61
56 220 ILCS 5/1-101 *et seq*.

discovery. For example, the Illinois TELRIC Order required tariffs to be implemented in February 1998, over 15 months after the docket was initiated.[58]

Because of these practical demands on the system, the ICC recommends that any effective streamlining to this process include placing constraints on the filings made by utilities. If the focus is limited to merely shorten the review process, then regulators will encounter increasing difficulty verifying the accuracy of the information provided and the quality of the resulting UNE rates will suffer.

In order to determine whether the cost studies advanced by an ILEC are in fact based upon currently existing strictures governing cost support for UNEs, and in order to permit a full review of the cost models and supporting cost studies, detailed sworn evidence and supporting data is essential. This evidence becomes even more crucial if a nine (9) month deadline is imposed on UNE rate proceedings. If the FCC is inclined to grant such a time constraint then it becomes imperative that the FCC require ILECs to file specific, detailed evidence up-front at the time the proposed rates are filed with the relevant PUC in order to allow the PUC sufficient time to conduct its analyses. This evidence would be in addition to any other testimony that an ILEC chooses to file in order to bear the burden of establishing that its proposed UNE rates are TELRIC compliant, cost-based, and just and reasonable.

The ICC recommends (particularly if a deadline is imposed) that for each of the following areas, an ILEC filing proposed UNE rates be ordered to provide at the time of such filing, (1) the assumptions most recently approved by the relevant PUC in establishing the rates which the ILEC proposes to change in its filing, (2) the changes in those assumptions proposed by the ILEC in its current filing and (3) all evidence relied

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[57] 220 ILCS 5/9-201(b)

on by the ILEC for its proposed changes; regarding:

1) Financial
   a. Capital structure
   b. Cost of equity
   c. Cost of debt
2) Fill factors
3) Shared and common costs
   a. Amounts in study
   b. How shared and common costs are allocated to direct costs.
4) Local switching – is the equipment that is the subject of the particular cost study usage sensitive? If the answer is "yes," provide the basis for the sworn assertion that the equipment is usage sensitive.
5) Collocation costs
   a. Rental costs for floor space at the Central Office
   b. Prices for constructing new equipment cages.
6) Power consumption – How charges are assessed to Competitive Local Exchange Carriers
7) Identify and explain each and every other change between the assumptions reflected in the cost studies most recently used by the PUC in determining a particular rate and the assumptions reflected in the cost studies upon which the Company relies to support the rate reflected in the Filed Rate Schedule Sheets.
8) Depreciation Rates

The ICC further recommends that for each of the changes in costs proposed in the ILEC filing, the ILEC be required, at the time of filing, to break down those changes into the following categories:

1) Changes due to increases or decreases in costs
2) Changes due to the different cost methodology used for the current filing
3) Changes due to proposed revisions of prior PUC/FCC rulings.

The ICC further recommends that at the time of filing the ILECs should also provide the following:

1) A cross-reference resource that lists the following for each UNE in which the ILEC is proposing rate increases in the Filed Rate Schedule Sheets:
   a) The tariff page for which the UNE rate is located.
   b) The cost model and all related spreadsheets and work papers used to develop the rate proposed in the Filed Rate Schedule Sheets.
2) Hard copies of all data residing on the CD-ROM discs provided by the ILEC to support the filing.

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[58] *TELRIC Order* at 1.

3) A detailed explanation of all changes to the descriptions, terms, or conditions made to elements in the Filed Rate Schedule Sheets.
4) A detailed explanation and justification for all rate elements reflected in the Filed Rate Tariff Sheets that, prior to the date of filing were either set at zero or did not exist.

The ICC also recommends that the ILEC be required to provide the following additional evidentiary support for the filing:

1) UNE rates based upon inputting all of the ILEC's proposed cost information into the cost model(s) used to develop currently effective rates.
2) UNE rates based upon inputting cost information most recently used by the PUC in question in developing currently effective rates into the cost model(s) used in the current rate filing.
3) A comparison of the output from the cost models used to develop currently effective rates to the output from the new models, using the same inputs as used in the new models for this tariff filing. If there are any differences in the outputs of the two models, identify and explain each of those differences.

For these reasons the ICC does not believe that it is in the public interest to simply restrict a UNE proceeding to 9 months.[59] Rather, the ICC recommends that the additional requirements noted above be incorporated into the process, with the information to be provided at the beginning of a UNE cost proceeding.

[59] NPRM, ¶150.

b. Transparency

The Commission seeks comment on the importance of transparency and verifiability[60]. The ICC strongly recommends that the Commission establish rules for ensuring transparency and verification. In Illinois, the ICC does not develop cost models for determining UNE costs for telecommunications carriers. Historically, ILECs have developed their own cost models in Illinois, and it has been the role of the ICC staff to perform a detailed review of these models to determine if they are capable of modeling TELRIC compliant UNEs. These models are invariably complex, generally consisting of numerous, sometimes hundreds, of spreadsheets and algorithms. It is imperative that states be equipped with the ability to fully examine the algorithms and assumptions underlying these forward-looking costs models, and be able to make modifications were applicable. Such capabilities are necessary for the purpose of litigating possible alternatives to the models proposed by carriers and arrive at appropriate UNE rates. As such, models filed by parties to estimate forward-looking costs cannot be "black boxes" or otherwise be opaque to expert scrutiny. In such a case, it is impossible to determine whether or not a cost study developed using such a model conforms to TELRIC principles.

In addition, the input data to the cost models must be verifiable (auditable) so that a state commission staff can trace the data to actual company information, to company contracts, or to other information that will show that the forward-looking costs being determined and used for setting UNE rates have some basis in fact. One of the ways this data can be verified, in addition to vendor contracts, is to look at several years of the FCC's Automated Reporting Management Information System ("ARMIS") data and

[60] NPRM, ¶41

develop some long-range trends, to see if the costs being used for setting UNE rates follow that trend line. Currently, the input data used in developing UNE costs is difficult to audit, and state commissions must place a great amount of trust in the ILEC providing the information and accept the information as fact, or the state commission must open a docketed proceeding and fully litigate the validity of the costs that have been provided by the ILEC. In Illinois, the ICC has opened formal proceedings to determine UNE rates for ILECs to charge CLECs[61].

As noted above, TELRIC studies provided by ILECs are both lengthy and complex. If the Commission directs that the TELRIC methodology be standardized and simplified, this will reduce the length and complexity of such studies and of the proceedings convened to evaluate them. When state commissions have standards for inputs and simplification of algorithms used in the cost models, determination of UNE costs and rates would be more closely related from one state to another.

The ICC recommends that the FCC establish these standards in the form of rules for transparency and verifiability (auditable). Such rules should require that any cost model be transparent to state commissions, through use of current information technology used in personal computer programming (such as Microsoft Access or EXCEL) and that data used as input to those cost models be fully auditable by using ARMIS data, vendor and union contracts as sources which could be projected into the future to determine forward-looking costs.

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[61] *See, e.g.*, TELRIC Order; Verizon North Inc. (f/k/a GTE North Incorporated) and Verizon South Inc. (f/k/a GTE South Incorporated): Petition seeking approval of Cost Studies for Unbundled Network Elements, Avoided Costs, and Intrastate Switched Access Services, ICC Docket No. 00-0812 (pending)(hereafter "*Verizon TELRIC Proceeding*")

2. Specific Network Inputs

The Commission seeks comment on its tentative conclusion that TELRIC rules should more closely account for real-world attributes of routing and topography of an ILEC's network in the development of forward looking costs[62]. However, as a practical matter, TELRIC models often rely on real-world attributes beyond wire-center locations. Therefore, the ICC believes the proposed modification in rules does not, in practice, represent a marked change.

The models that ILECs have presented to the ICC have consistently included network assumptions that account for the fact that ILECs provide numerous services in addition to plain old telephone service ("POTS") today, and that these additional service offerings require networks that depart from those necessary to provide only the most basic voice-grade POTS service. The cost and UNE pricing implications of building models based on such hybrid networks depend on both the economies or diseconomies of scope associated with the hybrid networks, and determinations as to what costs are recoverable through UNE rates and which are not. Therefore, rules permitting or requiring the UNE cost model to reflect the real-world fact that ILECs design the network to deliver multiple services will not, in practice, necessarily alter existing TELRIC cost estimates or UNE rates. See also our comments in Section III (B)(1)(b).

As stated above, the ICC urges the Commission to clarify that CLECs should not, through UNE prices, incur the costs of features, functions, and capabilities that the ILEC prohibits them from using. CLECs should, through UNE prices, incur the costs of features, functions, and capabilities the ILECs actually provide to CLECs (even if the

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62 *NPRM,* ¶52

CLEC elects not to use these features, functions, or capabilities). For example, SBC Illinois strives to provide a network where all loops greater than 12 kilofeet in length are served by a hybrid fiber-copper loop. While such a network may not be necessary for the provision of basic voice services, the real-world fact is that ILECs regularly deploy such networks (e.g., in order to provide residential data services such as DSL) and use these networks to provide both basic voice and other advanced services. In practice it is virtually impossible to model a forward-looking network that is used only for the most basic voice service with only the most essential features, functions and capabilities, because such a network does not exist, and there is no market for components for such a bare-bones network. In reality, even simple voice providers use networks with features, functions, and capabilities beyond those necessary to provide voice conversations.

The ICC recommends that, if the Commission wishes to release guidelines on network design assumptions, it should do so by acknowledging that there is a range of appropriate network assumptions, depending on population densities, geography, and other factors. Additionally, it should acknowledge that carriers are deploying networks that have advanced capabilities and are multifunctional in nature.

Furthermore, the ICC believes that there is nothing exceptional about the current requirement of the Commission's TELRIC rules to take the ILEC's existing wire centers as given[63]. As stated above, the ICC does not believe that taking other aspects of the incumbent's actual network as given necessarily conflicts with the overall forward-looking nature of TELRIC[64]. For example, taking the ILEC's existing Feeder-Distribution-Interface ("FDI") locations as given might be a reasonable approach to

[63] 47 CFR §51.505(b)(1)

[64] In fact, the Commission acknowledged this when it found that taking existing wire centers as given does not contradict the forward-looking approach to UNE pricing.

achieve the goal of more closely accounting for real-world attributes of an ILEC's network[65]. While it is true that the sizing of distribution areas (and thus the locations of the FDIs) is based on the ILEC's projections of demand and population growth at a particular point in time, the same holds true for regulators who make these decisions at a different point in time. It is unreasonable to pretend that past actions based on past projections about demand and customer locations do not have any consequences. The fact that circumstances change over time is a fact for even the most efficient and forward-looking network operator. It is a fact that an ILEC as well as a competitive carrier faces every day.

In keeping with the Commission's statement that "even if the objective is to replicate the results of a competitive market, an approach that reconstructs the network over time seems to be more appropriate than one that assumes the instantaneous deployment of 100 percent new technology[,][66]" it is not appropriate to assume continuously changing network design assumptions. Something that was deemed efficient two years, six months, or even two weeks ago might not be deemed efficient in light of the facts and circumstances existing today. The problem, as the Commission has acknowledged[67], is setting the right balance between continuously modifying network design assumptions, and not changing them at all over time. It is the ICC's opinion that the Commission should consider permitting state commissions to take into account (on a going-forward basis) the network design assumptions at the previous rate-setting

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[65] A hybrid loop has a copper distribution cable but a *fiber feeder cable*, and is served by a DLC system. A DLC system consists of a Central Office Termination ("COT" or "DLC-COT") installed at the Central Office, and a Remote Terminal ("RT" or "DLC-RT") installed in the field. The fiber feeder cable connects the COT and the RT. The RT is then connected to the Feeder Distribution Interface ("FDI") via a feeder stub (buried copper cable).

[66] *NPRM*, ¶68

[67] *See, e.g.*, NPRM, ¶¶53, 60

proceeding when it is time to evaluate UNE rates again. For example, the regulator should refrain from changing network assumptions, such as the appropriate distribution area ("DA") size, every time UNE rates are being set. In the event such network assumptions are being changed from one UNE rate proceeding to the next, the state commission should attempt to measure the impact such a change in network design has on other aspects of the network. This ensures that past actions have consequences that are taken into account, just as actions taken by any network operator carry consequences. If the Commission prescribes such an approach, the ICC urges it to bear in mind that the approach requires substantial resources and hypothesizing by state regulators. Not only would the regulator be forced to decide what DA size is deemed efficient (however defined) and thus, where, and how many, FDIs should be placed, the regulator also needs to estimate hypothetical distribution cable lengths.

Taking into account real-world attributes of the network also means making necessary modifications to the cost models when inputs reflect assumptions that are unrealistic today as well as in the future. For example, a cost model that ignores multi-dwelling units ("MDUs") and assumes that all residential customers live in single-family homes (and thus require a network interface device ("NID")) needs to be altered to reflect more closely the real world characteristics of the network. In other words, taking into account real world factors does not necessarily lead to increased TELRIC rates.

a. Network Routing and Construction

The Commission seeks comment on other principles that could be applied in deciding the appropriate network routing and construction techniques for costing purposes.[68] The ICC interprets the questions raised regarding network principles that would be applied in deciding the appropriate networking routing and construction techniques to be directed to ILECs and CLECs, therefore we will provide no comments other than those provided above.

The Commission seeks comment from state commissions on whether they have adopted cost models that are capable of reflecting existing network routing[69]. The ICC has adopted cost models provided by ILECs only after a considerable period of discovery and analysis, but has not developed its own costing models.[70] At the present time the ICC has not reviewed cost models from all ILECs. The ICC approved cost models provided by SBC Illinois in its *TELRIC Order*, but has not yet approved, and may not approve, the cost models that SBC provided in its most recent filing[71]. It is the ICC's opinion that models are capable of reflecting existing network routing, probably even better than the models can reflect forward-looking methodology. The ICC is currently reviewing a Verizon cost model in Docket 00-0812, but has not yet decided to approve the model for use in Illinois.

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68 *Id.* ¶ 65

69 *NPRM*, ¶66

70 *See, e.g.*, *TELRIC Order*

71 *See* Illinois Bell Telephone Company: Filing to increase Unbundled Loop and Nonrecurring Rates, ICC Docket No. 02-0864. As noted elsewhere, *see* Section III(C)(2)(d), *infra*, this proceeding was terminated by operation of law when the Illinois General Assembly enacted Section 13-408 of the Illinois Public Utilities Act, 220 ILCS 5/13-408. The U.S. District Court for the Northern District of Illinois enjoined enforcement of Section 13-408, and the Court of Appeals, in affirming this decision, directed us to reopen Docket No. 02-0864, a matter the ICC is currently undertaking.

b. Technology

The Commission seeks comment on its tentative conclusion that the network be reconstructed over time is more appropriate than one that assumes instantaneous implementation of new technology. The ICC recommends that the Commission continue its use of TELRIC as approved by the federal courts, but that inputs for determining costs be combined in a way to reflect the current network at what it would cost the ILEC to replace it or the CLEC to rebuild it.

c. Structure Sharing

The Commission asks parties to offer suggestions on how the Commission might provide guidance to state commissions on the method for establishing structure sharing percentages in light of its tentative conclusion that the pricing methodology should account for real-world attributes of the routing and topography of an ILEC's network.[72] The ICC will review with interest the comments of ILECs and CLECs on this issue, and intends to address this issue in its reply comments.

[72] *Id.*, ¶ 72

d. Fill Factors

The Commission seeks comment upon various questions relating to fill factors.[73] Likewise, the Commission seeks comment upon the question of depreciation lives of plant assets[74]. The ICC has considerable experience in determining fill factors and depreciation lives for the development of UNE rates that are consistent with the TELRIC principles previously established by the Commission. The ICC believes that the forward-looking fill and depreciation methodology, that it approved in its first *TELRIC Order*[75], is within the range of acceptable approaches . The following pages offer comments on these issues as they relate to the NPRM.

- **Impact of Illinois Legislation on UNE Rates**

The ICC established UNE rates for Illinois Bell Telephone Company (hereafter "SBC Illinois") in its first *TELRIC Proceeding*.[76] In that proceeding, the ICC determined that target fill factors and FCC depreciation lives are the most appropriate means of establishing TELRIC-based UNE rates[77]. The ICC continues to use these fills and depreciation lives for all UNEs. The ICC notes that the Illinois General Assembly has attempted to address the issue of fill factors and depreciation as these affect UNE rates. The following is a discussion of the legislation in question, and supplements the ICC's comments.

1. Illinois Legislation Requires Use of Actual Fills and Accelerated Depreciation for UNE Loop Cost Development

On May 9, 2003, the Illinois General Assembly enacted, and the Governor of

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73 *NPRM*, ¶¶73-75
74 *NPRM*, ¶¶94-101
75 *Order*, Docket 96-0486/0569 (Cons.)
76 *Id.*
77 *See TELRIC Order* at 32 *et seq*.

Illinois signed into law, Ill. P.A. 93-5, which was in turn codified, *inter alia*[78], as Section 13-408[79] of the Illinois Public Utilities Act. Section 13-408 recites that:

> The General Assembly finds and determines that it should provide direction to the Illinois Commerce Commission regarding the establishment of the monthly recurring rates that … incumbent local exchange carriers [subject to this Section][80] shall charge other telecommunications carriers for unbundled loops, whether provided on a standalone basis or in combination with other unbundled network elements, in order to ensure (i) that such rates are consistent with the requirements of the federal Telecommunications Act of 1996, the regulations promulgated thereunder, and subsection (g) of Section 13-801 of this Act, and (ii) that such incumbent local exchange carriers are able to recover the efficient, forward-looking costs of creating, operating, and maintaining the network outside plant infrastructure capacity and switching and transmission network capacity necessary to permit such incumbent local exchange carriers to meet in a timely and adequate fashion the obligations imposed by Section 8-101 of this Act[81].

Section 13-408 provides, in relevant part, that:

> The General Assembly directs that the Illinois Commerce Commission shall employ fill factors (the proportion of a facility or element that will be "filled" with network usage) that represent a reasonable projection of actual total usage of the elements in question, in accordance with applicable federal law. The General Assembly finds that existing actual total usage of the elements that affected incumbent local exchange carriers are required to provide to competing local exchange carriers, as reflected in the current actual fill factors for the elements in question, is the most reasonable projection of actual total usage. The Commission, therefore, shall employ current actual fill factors that reflect such existing actual total usage on a going forward basis in establishing cost based rates for such unbundled network elements.[82]

Section 13-408 further provides, in relevant part, that:

> The General Assembly further directs that the [Illinois Commerce] Commission shall employ depreciation rates that are forward-looking and based on economic lives as reflected in the incumbent local exchange carrier's books of accounts as reported to the investment community under the regulations of the Securities and

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78 P.A. 93-5 also enacted a provision, codified at 220 ILCS 5/13-409, that exempts a small number of access lines from the pricing regime established by Section 13-408 for a period of several years.

79 220 ILCS 5/13-408

80 Section 13-408 applies only to carriers subject to alternative regulation under Section 13-506.1 of the Illinois Public Utilities Act. 220 ILCS 5/13-408. Currently, the only such carrier is SBC Illinois.

81 220 ILCS 5/13-408. The ICC offers no opinion upon whether the General Assembly succeeded in accomplishing these stated goals.

82 220 ILCS 5/13-408(a) (emphasis added)

Exchange Commission. Use of an accelerated depreciation mechanism shall be required in all cases[83].

Thus, under Illinois law, the ICC was required to set UNE loop rates for such ILECs using each such ILEC's actual fill factors and actual booked depreciation lives. However, federal law stepped in.

2. Federal Appeal of Illinois Legislation

On June 9, 2003, the U.S. District Court for the Northern District of Illinois determined that Section 13-408 was "expressly contrary to federal law"[84]. The court found that the ratemaking process was properly adjudicatory, not legislative and the General Assembly's intercession in the ratemaking process was therefore prohibited[85]. The court therefore enjoined the enforcement of Section 13-408[86]. On November 10, 2003, the Court of Appeals for the Seventh Circuit affirmed the District Court's Order, [87].

The litigation surrounding section 13-408 prevents the ICC from commenting substantively in this area. Notwithstanding the legal challenges to the Illinois statutes, and the injunction against their enforcement, Section 13-408 has not been repealed and remains a part of the Illinois statutory scheme. Accordingly, the ICC, as a creature of the General Assembly, is to some degree constrained by this statutory guidance, and should depart from it with circumspection.

3. Impact of Illinois Legislation on TELRIC Costs

In compliance with Section 13-408, the ICC initiated a proceeding to establish

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83 220 ILCS 5/13-408(b) (emphasis added)

84 Voices for Choices, *et al.* v. Illinois Bell Telephone Co., *et al.*, 03 C 3290, 2003 U.S. Dist. Lexis 9548 at 29-30, (N.D. Ill. 2003) (June 9, 2003)

85 *Id.* at 29

86 *Id.* at 30

87 AT&T Communications of Illinois, *et al.* v. Illinois Bell Telephone Co., *et al.*, 03 – 2735; 03 – 2766, -- F.3d. --, 2003 U.S. App. Lexis 22961 at 22 *et seq.*, (consolidated)(7th Cir. 2003); the ICC declined to appeal from the District Court decision and is, accordingly, a nominal party to the ongoing proceedings.

new UNE loop rates based on actual fill levels and booked depreciation lives[88]. The ICC approved UNE loop rates in this proceeding on June 9, 2003.[89] Immediately thereafter, the federal court enjoined implementation of these rates, as discussed above. Nevertheless, the approved rates demonstrate what would have been the impact of moving from forward-looking fill factors and depreciation lives to actual levels for these factors with respect to a large ILEC, SBC Illinois. The following table shows the impact on TELRIC costs of providing UNE loops in Illinois[90]:

Percentage Increase In TELRIC Cost:			
	Access Area A	**Access Area B**	**Access Area C**
2-Wire	131%	110%	94%
Ground Start	130%	107%	90%
COIN	130%	107%	89%
EKL	129%	103%	84%
4-Wire	130%	106%	89%
BRI/ISDN	132%	116%	89%
2-Wire xDSL	129%	82%	67%
4-Wire xDSL	129%	82%	67%
DS1	52%	76%	65%

This table shows that TELRIC costs increase significantly for all types of UNE loops offered by SBC Illinois, solely as a result of moving from forward-looking to embedded fill factors and depreciation lives, as the state legislation would have required. The TELRIC for most types of loops are doubled by this change. Such a disparity leads the ICC to conclude that appropriate pricing signals could not be established by strict adherence to either forward-looking or embedded factors. While it has been argued that current TELRIC rates are too low, using actual (embedded) data would not be indicative

88 *See Order*, Illinois Commerce Commission On Its Own Motion: Petition to Determine Adjustments to UNE Loop Rates Pursuant to Section 13-408 of the Illinois Public Utilities Act, ICC Docket No. 03-0323 (June 9, 2003) (hereafter "*Section 13-408 Order*")

89 *Section 13-408 Order*

90 The percentages in this table were derived from TELRIC values listed in Schedule 1 to Staff's Initial Comments in the Section 13-408 proceeding.

of forward-looking costs or an efficient network. The ICC understands that the Commission seeks to simultaneously set efficient entry signals and provide incumbent LECs an opportunity to recover their forward-looking costs[91]. In fact, the goal of competitive entry is currently being achieved in Illinois as a result of pricing UNEs through the use of target fills and depreciation lives.[92] It appears to the ICC that carriers are reducing rates for residential access line and usage packages -- evidence that competition is starting to bear fruit in the state. For example, SBC Illinois has tariffed a number of packages combining local service and intraLATA toll along with services such as call forwarding, caller ID, etc. Since being approved to offer interexchange service in Illinois, SBC's LD carrier has also offered a flat-rated package of long distance service for use with a specific local and vertical services package. This package may also be combined with advanced (DSL) services. AT&T and MCI also offer flat-rated services that include unlimited local and long distance, advanced and vertical services. The ICC notes that if TELRICs increase to the point where UNE rates approach retail rates, this trend will not continue.

Because it is a theoretical concept, the modeling of forward-looking costs can be defined in many different ways. However, what concerns the ICC is the impact of such a definition. The ICC determined in its *TELRIC Order* that forward-looking costs are most appropriately recovered through forward-looking fills and depreciation lives[93]. Other than the change in Illinois statute discussed above, the ICC has not been presented with any

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91 *See, e.g.*, NPRM, ¶¶3-4

92 *TELRIC Order*

93 *TELRIC Order* at 21 *et seq*.

compelling evidence showing that this is not an appropriate means of setting UNE rates. Because of the dramatic impact any transition to a more embedded definition, (that is, the use of actual fills and accelerated depreciation) of forward-looking costs has on UNE rates as shown above, the ICC is reluctant to alter existing UNE rates without a rate proceeding.

e. Switch Discounts

The Commission seeks comments on the appropriate methodology for calculating forward-looking switch prices[94]. The ICC will address different issues related to setting forward-looking switch prices.

Under existing TELRIC rules, the forward-looking economic cost per unit for a UNE must equal the total cost of providing the network element divided by its total demand[95]. The calculation of the total cost of the unbundled switch UNE, however, is not straightforward, and is complicated by the fact that switch vendors typically offer multi-tiered switch prices — *i.e.*, a substantial discounts for new (or replacement) switches ("new discount") and smaller discounts for growth additions, or upgrades to existing switches ("growth discount"). A key issue facing regulators is *what discount* should apply in setting forward-looking switch prices or calculating the total cost of an unbundled switch network element. Under current Commission rules and regulations, state commissions "may reasonably take into account that there will be growth in the network in the future, and that it may not be cost-effective to acquire all of the projected need at the outset," and forward-looking switch prices may reflect a reasonable mix of new and growth discounts.[96] The current FCC rules and regulations, however, do not provide sufficient guidance on what constitutes a "reasonable discount mix" for purposes of setting forward-looking switch prices.

If forward-looking switch prices are based on the weighted average of the new

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94 *NPRM*, ¶76

95 See. 47 CFR 51.511(a)

96 *Memorandum Opinion and Order*, ¶82, In the Matter of Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., And BellSouth Long Distance, Inc for Provision of In-Region, InterLATA Services In Georgia and Louisiana, FCC No. 02-147, CC Docket No. 02-35 (May 15, 2002)

discount and the growth discount, then a key consideration becomes the choice of weights (*i.e.*, choice of discount mix). That is, in setting TELRIC rates, states must determine what percentage of the switch should be assumed to be new/replacement and what percentage should be assumed to be growth/addition for purpose of setting the forward-looking switch prices. The forward-looking switch prices vary greatly with the choice of discount mix, because new and growth discounts may differ significantly (*e.g.*, new discounts can be as high as 100% -- new switch prices can be as low as zero). The lack of guidelines on the appropriate weighting of the new discounts and growth discounts under current FCC rules may, in practice, result in a wide range of forward-looking switch prices set by state commissions. Invariably such variability results in costs differences that do not result solely from genuine cost differences.

1) *Time-Inconsistency in Switch TELRIC Setting*

Regardless of the regulations ultimately prescribed, the Commission (and state commissions) must recognize the reality that forward-looking switch prices are not set *permanently*, and they are generally set or reset every few years, typically after the ILEC renegotiates its switch contracts. Also, the time interval between setting switch prices is typically shorter than the life (or economic life) of the switch. Any attempt to set forward-looking switch prices would suffer the flaw of time-inconsistency if it fails to reflect this fact. By way of example, assume that a switch cost study is conducted every 5 years (starting in year 2000) and that the economic life of switch is 15 years. Under a 100% initial new switch purchase assumption (i.e., the assumption that in the initial year of the study all switching investment is investment to purchase new switches and investment in subsequent years is investment in existing switch expansion/growth additions) a year 2000 switch cost study would assume all switches are purchased in year

2000 and a growth additions are made in each of the subsequent years during the life cycle of the switch (*i.e.*, from 2001 to 2015). Similarly, a 2005 cost study would assume that all switches are purchased in 2005 and a growth additions are made from 2006 to 2020, and so on. That is, the 2000 cost study assumes that all investment in 2005 is for growth additions while the 2005 study assumes that there is no investment for growth additions in 2005 (*i.e.*, 100% new or replacement switches). This time-inconsistency is a result of proposed forward-looking switch price methodologies that make the 100% new switch assumption. There is no guidance in existing rules on how or whether to account for the use of contradictory assumptions across rate setting proceedings over time despite the fact that the occurrence of such problems is predicable. Failure to correct for such problems can lead to outcomes that do not comport with sound economic principles. For example, one consequence of this time inconsistency feature is that switching costs over time will reflect new switch discounts to a much greater extent than what any efficient telecommunications carrier incurs in practice. This prevents ILECs from recovering their forward-looking (not actual or embedded) switch cost, which in turn discourages the ILEC from investing in switching network element.

The Commission should adopt rules requiring time-consistency in the development of forward-looking switch costs. State commissions setting forward-looking switch prices should be required to take into account the fact that forward looking switch costs will be revised or reset every few years and the fact (or possibility) that the appropriate assumptions underlying the switch TELRIC (currently being set) would be different depending on whether there will be a subsequent cost study (setting forward-looking switch prices) to be expected.

2) *Actual Dynamic Aspect of Switch Investment*

In practice, a switch is purchased over time as an entirely new (or replacement) switch, and growth equipment is also added over time to a switch during the switch's life span. Switch investment at any point in time partially goes toward new (or replacement) switching and partially goes toward growth additions. This is an essential feature of an efficiently designed and operated network, and is consistent with long term or dynamic production efficiency. Instead of assuming that all switches are purchased at the outset and growth additions are made subsequently, a forward-looking switch cost study should reflect this "actual" dynamic reality of switch investment. Future Commission rules should reflect this.

One possible approach that would capture the actual dynamic aspect of switch investment is to utilize the new-growth ratio (or mix) that efficient firms would experience when operating in markets over time. One major advantage of this approach is that it does not rely on assumptions that suffer the time-inconsistency flaw described above. In addition it properly accounts for the blend of new and growth discounts and vendor switch prices that efficient carriers would incur over time.

3) ***Actual Discount Mix***

Contracts between switch vendors and LECs generally contain or are developed based on projections of new switch and growth addition investment. One possible approach to modeling the blend between new switch and switch growth investment is to utilize the discount mix underlying the switch contract. This approach, however, has serious flaws. Under this approach, the switch TELRIC or forward-looking switch prices may be rising even though all vendor switch prices are declining. Because of short run fluctuations in individual carrier growth rates, the new-growth discount mix underlying an ILEC's switch vendor contract can vary greatly from one contract to the next

(renegotiated) contract. That is, the new-growth mix in the next (renegotiated) contract can be substantially more tilted towards growth addition than the discount mix underlying the current switch contract. Thus, even as all switch prices (new and growth) decline, the switch TELRIC and forward-looking switch prices may be rising due to higher percentage of growth addition investment.

This actual-discount-mix approach (i.e., looking at actual new vs. growth mixes for a particular carrier at a particular point in time) reflects a *short-run* approach to modeling switch investment. Forward-looking switch prices should be based on Total Element Long Run Incremental Cost, which is by definition a long run concept (see 47 C.F.R 51.505(b), it would be more appropriate to apply the dynamic long run equilibrium discount mix in setting forward-looking switch prices.

D. Cost of Capital

The Commission seeks comment upon many cost of capital questions related chiefly to the Commission's proposals to modify the current UNE pricing rules to more closely reflect the cost of the existing network of an incumbent LEC and to include different costs of capital for different network elements[97].

In particular, the Commission seeks comment regarding whether state commissions should continue to reflect the risks of a competitive market in calculating the cost of capital even if the Commission adopts a UNE pricing methodology that is tied more closely to the existing network of an incumbent LEC[98]. The ICC believes that the Commission should, whatever it elects to do, adopt consistent assumptions regarding competition and operating costs. For example, the assumption of a competitive environment would indicate an efficient network,[99] which would produce lower operating costs and lower profit margins, which would increase risk and consequently, increase the cost of capital. In contrast, the assumption of higher operating costs due to a less than efficient network implies a less competitive market, which would produce a lower cost of capital. Thus, should the FCC decide to adopt a UNE pricing methodology that is tied more closely to the existing network of an incumbent LEC, it should also assume a level of risk reflective of the existing state of competition. Ultimately, whatever level of efficiency, (i.e., competition) the FCC decides to reflect in its operating assumptions will dictate, on a sliding scale, the cost of capital that states should adopt.

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97 *NPRM*, ¶82 *et seq*.

98 *NPRM*, ¶¶83-84.

99 Competitors would have to operate efficiently to survive in a competitive market.

This notwithstanding, the ICC believes the adoption of a UNE pricing methodology that is tied more closely to the existing network of an incumbent LEC is at odds with the FCC's own directive that pricing should be forward-looking[100]. That is, the ICC believes that forward-looking UNE pricing should not reflect the existing network of an incumbent LEC, but rather, should reflect the efficient operations that will be effected by the competition that the Commission is striving to foster.

Given that the primary objective of the 1996 Telecommunications Act is to introduce competition, it is reasonable to assume a forward-looking UNE pricing model will replicate as closely as possible those costs that would exist in a competitive environment. Economic theory also suggests that the existence of competition will pressure competitors to become more efficient. Thus, the Commission's ultimate policy for UNE pricing, including its policies regarding cost of capital, should be based on assuming efficient operations and some level of competitive risk. Such an approach reflects the consistency in assumptions regarding competition and operating expenses that we feel is desirable.

The Commission seeks comments on how to quantify the various components of risk that should be reflected in a company's cost of capital[101]. The ICC does not believe it is possible to empirically quantify units of risk and specifically measure the associated cost of capital. Thus, the ICC can only approximate risk through a sample of generally comparable companies, with similar business risks.

The Commission also seeks comments regarding the determination of an

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[100] The NPRM reaffirms that costs reflected in UNE prices, including capital costs, should be forward-looking. *See* NPRM, ¶¶ 29, 37.

[101] *NPRM*, ¶85.

appropriate capital structure[102]. Incremental investment can be funded with debt, equity, or any combination of the two. An ILEC's current and target capital structures generally guide the decision of how to finance incremental investment. The ICC believes that a forward-looking cost of capital should reflect the optimal, marginal capital structure, which would minimize the cost of capital and maintain a reasonable level of financial strength. However, determining whether a capital structure is optimal remains problematic because: 1) the cost of capital is a continuous function of the capital structure, rendering its precise measurement along each segment of the range of possible capital structures problematic; 2) the optimal capital structure is a function of operating risk, which is dynamic; and 3) the relative costs of the different types of capital vary with dynamic market conditions. Consequently, one should determine whether the capital structure is consistent with the financial strength necessary to access the capital markets under most conditions, and if so, whether the cost of that financial strength is reasonable.

The Commission seeks responses to a number of questions regarding the risk of losing customers to facilities-based competitors[103]. The ICC believes the Commission should recast its examination to focus on the effect of competition on the local market overall, rather than any individual competitor. The ICC believes that the risk associated with competition stems from a reduction of return due to downward pressure on prices for all competitors, rather than from the threat of individual competitors losing customers. For example, a diversified investor who invests in all local competitors would be indifferent to which competitor serves which customers. However, the fact that competition will likely drive prices down, while each competitor will still incur fixed costs, will reduce each competitor's operating margin, which will put that same investor

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102 *Id.*

at risk. The ICC is not aware of any way to precisely quantify this risk. Nevertheless, competition will increase the risk to competitors by reducing profitability from monopolistic levels to a normal economic profit. In addition, whether risk is always higher in a fully competitive market than in a market in transition from monopoly to competition depends on how the transition into competition is implemented.

The NPRM seeks comments on how the Commission may simplify the task of setting the cost of capital and asks if any reason exists that would cause the cost of capital to vary among different states or among different companies[104]. Theoretically, the cost of capital could vary among different states. However, the ICC is not aware of any practical way to measure the level of risk associated with location with any precision. The cost of capital may vary among different companies, as well. An analyst can, to some extent, differentiate between their risks by analyzing each company's financial ratios. With regard to appropriate models, the discounted cash flow and capital asset pricing models are the only two models the ICC has consistently approved for determining the cost of capital.

The Commission seeks comments on the appropriateness and practicality of establishing different costs of capital for different UNEs[105]. Although, theoretically, one would be able to identify the risk level of the various elements of a company's operations in order to assess the costs of those elements, such an approach would not be feasible for UNE rate setting for the following reasons: 1) the risk of individual UNEs cannot be measured with enough precision to differentiate between most elements, 2) such an approach is not likely to be consistent with the manner in which LECs actually raise

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103 *Id.*, ¶86.
104 *Id.*, ¶88.
105 *Id.*, ¶¶89-91.

capital (i.e., the LEC and its investors are likely to assess risk on a project basis rather than on an individual element basis and, thus, separate financing is not raised for different UNEs), and 3) such an approach would not be practical from an administrative perspective, as the process would be very time-consuming due to the number of UNEs for which different costs of capital would have to be derived, and would produce very little benefit, if any, relative to using a single weighted average cost of capital for all UNEs.

In summary, the ICC recommends that a single weighted average cost of capital be used for all of a given ILEC's UNEs. That cost of capital should reflect a level of competitive risk consistent with that implied by the operating cost assumptions the FCC chooses.

E. Depreciation Expense

The NPRM contains several points and requests for comment related to the issue of depreciation rates[106] and the closely related issue of asset lives[107]. The Commission appears to accept the presumption that depreciation rates are significant factors in providing recovery of asset costs, sending price signals to customers, and providing capital for investment in immerging technological advances[108].

The ICC believes that, regarding the regulated ILECs, the issue of depreciation must be framed within the bounds of historical regulation. It is important to recognize that depreciation is an allocation process, not a costing process. That is, the depreciation expense is applied over the life of the asset. More specifically, once acquired, the cost of an asset is sunk, therefore the depreciation process has no impact on the cost. Whether an

asset is depreciated over three years or fifty years, its total cost to the owner is unchanged.

Decisions regarding the recognition of depreciation expense for UNE pricing purposes should be guided by the goals of the pricing process. If the goal is to provide lower network element rates, then it is reasonable to use long asset lives, with lower depreciation rates, lower UNE prices, and a decrease in the ILEC's ability to recover funds quickly to invest in more modern technology. If the goal of UNE pricing is to provide the ILEC with funds to invest in more modern technology, then shorter lives that increase UNE prices and UNE revenues, are appropriate. Because UNE costs will

106 *NPRM*, ¶103*, et seq*.
107 *NPRM*, ¶99, *et seq*.
108 *See NPRM*, ¶94 , *et seq*.

increase as ILECs accelerate depreciation by using shorter depreciation lives, it is not possible to reduce asset depreciation lives and at the same time reduce network element rates. Depreciation expense is an accounting function, rather than recognition of current operating cash expenditures.

Because depreciation expense is a part of the TELRIC, some balance must be derived between the actual costs and life of assets and the recognition of expense included in the rate for a UNE. If the Commission decides to allow ILECs to accelerate depreciation, and charge higher TELRIC rates when assets are first purchased, then there must be some built-in mechanism in TELRIC to lower rates as depreciation expenses are lowered (after initial depreciation expense is recorded in the early life of an asset).

1. Asset Lives

The Commission notes that it has been reluctant to rely solely on financial reporting lives out of concern that Generally Accepted Accounting Principles (GAAP) might permit companies to adopt depreciation methods that result in excessive depreciation expense, and asks for comments on this reluctance in the context of UNE rate-setting[109]. The ICC does not believe it is appropriate to rely on financial reporting lives, but not because they could allow for the recovery of excess depreciation. Financial reporting depreciation is developed for the purpose of identifying the financial health of a utility, not for the purpose of cost recovery. While financial depreciation lives would not allow for the recognition of depreciation expense in excess of the cost of an asset, the depreciation rates for UNE pricing purposes should be developed based on the goals of the UNE process: i.e., lower prices for competitive purposes or higher prices to increase revenue streams to the ILEC. Direction to the states relative to depreciation lives should be consistent with the goals of the Commission.

The Commission also seeks comment upon whether financial lives used to develop earnings reported to shareholders match those that companies use to plan their future capital expenditures[110]. The ICC believes that decisions on the length of depreciation lives to be used for financial reporting purposes are generally driven by a company's desire to maintain the lowest total expense that can be honestly reported to shareholders. Thus, by example, depreciation lives for financial reporting purposes are generally longer than lives for tax reporting purposes. For UNE purposes, if the FCC believes an ILEC should recover its investment quickly, then the use of shorter lives is appropriate. If the FCC believes lower rates should be charged to the competitive

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[109] *NPRM*, ¶98

carriers, then the use of longer depreciation lives is appropriate.

The Commission also seeks comment on how financial reporting lives are developed and whether they accurately represent the anticipated economic life of assets[111]. Specifically, the Commission solicits comment upon how financial reporting lives reflect the potential impact of future technologies[112]. The ICC believes that the telecommunications industry has traditionally developed depreciation lives for both financial reporting and rate-setting purposes to reflect the economic life of the asset. However, this is more a result of the regulatory process, and the attendant goal of maintaining stable rates from one year to the next, rather than GAAP. Because future technologies are unknown, financial reporting lives do not directly reflect the impact of future technologies. However, they can reflect obsolescence that resulted from past technological advances.

With respect to the major categories of plant and equipment (switching, loops, interoffice transport), the ICC has found no objective evidence that anticipated changes in technology will cause equipment installed today to have shorter lives than equipment that was installed for the same purpose in the past. The ICC has also found no objective evidence showing that potential advances in technology may actually lengthen the useful life of some types of assets. The ICC does believe that the actual retirement experience of an incumbent LEC is relevant for pricing UNEs, and the Commission must, in any case, obtain relevant evidence from the ILEC community. For pricing decisions in a competitive environment, the answer to the question of how best to recognize the cost of obsolete assets is moot because the market sets the prices. If the goal is lower prices to

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110 *NPRM*, ¶99
111 *NPRM*, ¶99
112 *Id*.

CLECs or end users, then the use of longer asset lives can be supported on the concept that we don't know when, or if, assets will become obsolete. If the goal is higher prices to customers, then the use of shorter asset lives can be supported on the on the theory that history demonstrates that assets will become obsolete.

The Commission further seeks comment on whether compliance with GAAP results in any systematic bias[113]. It seeks comment upon whether the "conservatism" principle underlying GAAP leads to a downward bias in asset lives[114]. Finally, the Commission expresses concern regarding the possibility that the use of different asset lives for different regulatory purposes creates incentives for regulatory arbitrage[115].

Because the determination of asset lives for depreciation is a very subjective matter, the ICC notes that GAAP provides significant discretion. The goal of determining depreciation lives is to allocate cost over a reasonable time period as determined by other goals, such as identifying an entity's income or determining the cost of providing service. While principles of GAAP, particularly the conservatism convention, might have a downward bias on asset lives, the nature of depreciation expense, i.e., non-cash, rather than depreciation lives, is of greater concern with regard to GAAP. The ICC is not sure that "regulatory arbitrage" is necessarily the term most descriptive of the practice the Commission decries, but notes that the use of multiple asset lives certainly can create cash flows in a regulatory environment that would otherwise not exist. This concern does not exist with market-established prices.

113 *NPRM*, ¶100
114 *Id.*
115 *Id*.

The Commission also asks parties to comment on whether FCC regulatory lives reflect the competition and technology assumptions required under a forward-looking costing methodology[116]. The ICC notes that the information it possesses is provided to it by ILECs, and therefore it cannot state positively whether or not the FCC lives currently in place are reflective of real world attributes of the network. In Illinois, the current UNE rates are reflective of FCC asset lives. These will be reviewed soon in a new UNE case that will be initiated before the ICC, as directed by the recent federal court decision that enjoined enforcement of the Illinois statute that also spoke to this issue[117].

[116] *NPRM*, ¶101

[117] See AT&T v. Illinois Bell, 2003 U.S. App. Lexis 22961 at 23-24; *see also* Voices for Choices, 2003 U.S. Dist. Lexis 9548 at 30.

2. Depreciation Rate

The Commission asks parties to comment on the relationship between the rate of change in equipment prices and the rate of change in final product prices.[118] Specifically, it seeks comment on the extent to which companies in competitive markets consider changes in the economic efficiency of assets (*e.g.*, price changes, technological advances) in deciding how quickly to recover investments[119].

In response, the ICC observes the amount of revenue that a company collects is a function of the competitive environment. Specifically, it is a function of the extent to which the company in question is successful in selling its goods or services at rates that are controlled by the market. Accordingly, the amount of revenue collected is not a function of a company's costs. Once collected, the revenue can be used to pay operating expenses, to meet working capital needs, to make new investments, or given certain constraints, to pay stockholders. If the market is truly competitive, the companies in that market will have little or no pricing power. Price will be based on what it takes to compete. Consideration of changes in technological efficiencies is reserved for investment decisions, not pricing decisions.

The Commission requests comments on levelization of rates that occurs in most cost models, an outcome that it believes to be inconsistent with the concept of adjusting UNE prices to reflect anticipated changes in equipment prices[120]. The ICC has to date ruled upon UNE cost models provided by SBC, and is currently examining a model provided by Verizon.

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118 *NPRM*, ¶103
119 *Id.*
120 *NPRM*, ¶106

The ICC cannot comment on this issue without additional input from the Commission on exactly what levelization processes it refers to.

The Commission observes that an alternative method of reflecting economic depreciation might be to recover through depreciation expense the difference between the current value of the asset and the anticipated value of the asset at the next rate proceeding, and asks parties to comment on this approach to economic depreciation and to identify other approaches that might be used [121]. In response, the ICC notes that depreciation is a method of allocation and not valuation. The value of an asset is unrelated to the method, or amount of depreciation. The value of an asset is dependent upon future cash flows to be generated by that asset. A $1 million asset having an economic life of 30 years could be fully depreciated in one year. (that is, depreciation expense in year 1 is $1 million) However, if that asset will generate $5 million in year 30, its value in year 30 would far exceed zero. If the goal of the Commission is to provide recovery of cost, (either past or future) then there is no reason to consider the changing value of an asset, because any changing value is unrelated to cost. The issue is not *whether* expectations about prices prove to be incorrect, but rather *when* expectations prove to be incorrect, and by *how much* these expectations are incorrect. Assuming that depreciation is to be set based on value, then if expectations prove to be materially incorrect, then any valuation, depreciation, and ultimate rates will need to be reset. This is one reason that the concept of setting rates based on the changing value of assets is difficult to envision and likely to be fraught with error. In reality, the value of all assets is constantly changing and valuation is a poor basis for determining depreciation expense.

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[121] *NPRM,* ¶107

In light of the potential difficulties associated with some of the mechanisms described above, the Commission seeks comment on whether a reduction in asset lives might be used as a proxy for changing investment costs[122]. Specifically, the Commission seeks comment upon the circumstances under which a carrier would retire an asset before the end of its useful life[123]. The Commission asks whether, once an asset is in service, it is reasonable to assume that it would be retired early only if the net present value of the expected future cash flows associated with buying and operating new technology is higher than the expected cash flows associated with operating the old asset[124]. Likewise, the Commission asks whether, if the use of shorter asset lives increases the amount of cost recovery, this is an appropriate method of reflecting anticipated technological improvements that would lower costs[125].

In response, the ICC observes that anticipated technological improvements have traditionally had a negative impact on asset lives. That is, asset lives have been reduced because technological advances render assets utilizing older technology obsolete. The problem is that no one can accurately predict what technical advances will occur, and when they will occur. Forty years ago, it was anticipated that personal desktop telephones would one day contain cathode tubes. This has not yet occurred. There are numerous similar examples of technological prognostications that have not come to fruition, while others have emerged unexpectedly[126].

However, and more significantly, it must be remembered that the cost of an obsolete asset is entirely irrelevant to a decision to invest in a new asset. The relevant

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122 *NPRM*, ¶108

123 *Id.*

124 *Id.*

125 *Id.*

126 This being December 2003, the ICC notes that the advent of powered flight, which first took place

comparison is the cost of the new asset plus the cost of operating the new asset plus the avoided cost (net of revenues) of operating the obsolete asset against the revenues to be obtained from the new asset. (The cost of the old asset itself is a sunk cost of investment, not an operating cost.) There is a real risk of over-recovery with shorter asset lives. However, if over-recovery occurs, it is possible to rectify the situation by lengthening the life of any replacement. The ICC is of the opinion that unregulated companies address uncertainties associated with advancing technologies through their return on equity. When an asset becomes obsolete, they must replace the asset whether they have "recovered" its cost or not. The entity's earnings will suffer and the stockholders will in effect pay for the remaining cost of the asset. The depreciation life is irrelevant to the recovery of the cost of the investment. The use of a shorter asset life will reduce return available to stockholders.

For example, if an asset costs $1 million and its depreciation life is set at one year, the impact on stockholders is a $1 million reduction in return in year one. If the depreciation life of the asset is 40 years the impact on stockholders is still a $1 million reduction in return, but it occurs over 40 years. Neither non-regulated, nor, regulated companies actually "recover" cost. All companies collect revenues that are used to pay costs such as salaries, maintenance, return to stockholders, (if there is no return for stockholders, the company will cease operations) and purchase of new assets. The difference is that competitive companies charge prices that are set by the marketplace (theoretically) whereas regulated companies charge prices that are set equal to the company's cost (theoretically). At the time an investment is made, competitive

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100 years ago this month, was quite unexpected at the time by everyone but the Wright brothers.

companies must decide if the investment will generate an adequate return on equity. If new technology renders the investment obsolete, the stockholders will cover the cost of the obsolete investment through a reduction in return on equity.

F. Expense Factors

Annual cost factors ("ACFs") have been used extensively in the development of TELRIC costs in Illinois. The ICC sees no compelling reason to depart from ACF methodology. Anticipated changes in expenses can be integrated into ACF development as easily as they can be integrated into another methodology because annual cost factors have been used for costing purposes for many years by companies such as SBC, Verizon and other ILECs. The ICC sees no clear advantage that one method has over another, as long as the modeling techniques in use can accommodate all necessary adjustments. The process of litigating UNE proceedings allows for parties to propose adjustments to ACFs and argue for their reasonableness before the ICC. Such a process, the ICC believes, is the one most likely to accurately estimate forward-looking costs for UNEs.

The Commission seeks comment on whether it is correct to assume that expenses will be reduced in proportion to reductions in investment[127]. The ICC notes that once an ACF is established, the expenses that it yields will move in proportion to the amount of investment. However, if a party proposes that a certain level of investment be modified, it is prudent to examine whether ACFs must also be modified, as investment levels and ACFs are quite obviously interrelated. Therefore, the assumption that expenses will somehow be reduced in proportion to investment cannot be examined in a vacuum. The ICC would not ignore a persuasive argument that would potentially compel it to revisit ACF development as a result of changes to investment. As such, the ICC recommends that the Commission not simply assume that expenses will necessarily change in proportion to investment. Further, the ICC is not aware of any alternative method of

[127] *NPRM*, ¶104

estimating forward-looking expenses, and therefore provides no arguments concerning their relative merit.

G. Non-Recurring Charges

1. Identification of Costs

The Commission also inquires about whether a presumption should be made that an incumbent LEC's current practices with respect to non-recurring charges ("NRCs") are efficient or are an incumbent LEC's incentives to be efficiently diminished when competitive LECs are the primary users of a particular activity[128]. The ICC is of the opinion that current practices may not be the best indicator of the most efficient forward-looking practices. The ICC believes that this is most likely a function of the relative newness of local exchange competition. As the ILECs' practices evolve, they should become more efficient. Accordingly, the ICC believes that the Commission should not presume that current practices are efficient.

The Commission also asks parties to comment on manual activities that are not susceptible to automation[129]. The Commission asks how state commissions might develop more objective evidence. The ICC has sought precisely such information in several of its proceedings. Specifically, it has requested such information from SBC in supporting its development of non-recurring charges in two dockets[130]. It has suggested that the ILEC use time and motion studies[131]. Alternatively, the ICC has accepted an approach that relies on the estimates of subject matter experts[132]. The ICC further suggested that such an approach should be supported by the identification and documentation of forward-looking workflows, identification of estimators, the development of detailed written estimation instructions, provisions for averaging the individual estimates, and the

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128 *NPRM*, ¶119
129 *Id.*
130 *See, generally*, *TELRIC Order*, *TELRIC II Order*
131 *TELRIC Order* at 92
132 *Id.*

development of documentation[133]. The ICC addressed the recovery and allocation of common costs for UNEs in the *TELRIC Order*. The ICC adopted "extended TELRIC" as a means of recovering common costs in that order[134]. In essence, the extended TELRIC methodology required that SBC Illinois' common costs be allocated to UNEs via a weighted average of their respective TELRIC costs. Subsequent to the initial establishment of shared and common cost allocations, SBC Illinois has applied a fixed percentage of TELRIC for the recovery of overhead costs for new UNEs. The ICC has found this to be a simple and equitable means of allocation.

The ICC has not prohibited the recovery of common costs through nonrecurring charges, simply because it would be difficult, if not impossible, to totally eliminate shared and common cost recovery from nonrecurring charges,--regardless of how desirable such an outcome might be. Nonrecurring charges are traditionally labor intensive, and labor rates are traditionally loaded to include some common costs such as tools, vehicles and supervision. However, the ICC acknowledges that, whenever up-front nonrecurring charges are increased, it represents a potential barrier to competitive entry. As the cost of entry into a market increases, the ability of competitors to enter a market decreases. As such, the ICC would not object to a requirement that common costs only be recovered via recurring charges. However, the ICC notes that it allowed allocation of shared and common costs to NRCs in the *TELRIC Order,* and therefore observes that current

133 *Id.*

134 *TELRIC Order* at 54.

TELRIC NRC rates for SBC Illinois do include allocation of the shared and common costs.

2. Recovery of Costs

The Commission asks if NRCs should only recover those costs that exclusively benefit the competitive LEC ordering the UNE, noting that this approach provides a mechanism by which an incumbent LEC can recover the cost of activities related to the initiation of service by CLECs, while reducing barriers to entry, and further noting that costs for activities not permitted for recovery through NRCs would be recovered through expense factors used in developing recurring charges.[135]. The ICC believes that this would be a proper finding for the Commission to adopt. The ICC also believes that the Commission needs to provide a clearer standard with respect to NRCs. Only NRCs directly attributable to activities benefiting the competitive LEC should be recovered from the CLEC.

The Commission questions whether it is appropriate to impose NRCs on installing a cross-connect at a Feeder/Distribution Interface ("FDI") if the cross-connect remains in place after the customer terminates service[136]. In this instance, the ICC believes that a NRC should not be imposed. The Commission also asks if an NRC should be imposed in an instance where a cross-connect is being made from a Main Distribution Frame ("MDF") to a CLEC's collocation space. In this instance, the activity is being performed solely for the benefit of the CLEC. As such, a NRC should be collected from the CLEC.

The Commission inquires whether allowing ILECs to recover NRCs for every activity related to provisioning service for a CLEC removes an incentive for the ILEC to develop automated processes[137]. The ICC, in the TELRIC proceedings conducted before it, has ordered that where possible, automated processes should be used in development

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135 *NPRM*, ¶121
136 *NPRM,* ¶122

of non-recurring charges[138]. The ICC believes that non-recurring activities are no less forward-looking than recurring activities. Forward-looking means assuming a great deal of automation. Properly defining the forward-looking framework will result in developing NRCs that incent the ILEC to adopt the most efficient processes.

137 *NPRM*, ¶124
138 *TELRIC Order* at 92-93

3. Disconnection Costs

The Commission asks parties to comment on the proper way for ILECs to recover disconnection costs[139]. In Illinois, ILECs are allowed to include disconnection costs in the development of the NRCs for retail customers. These disconnect costs for retail are collected from the end user when the service is established. Accordingly, the ICC is not necessarily opposed to the notion of including disconnection costs in the loop connection charges collected from CLECs. However, the ICC shares the Commission's concern about the difficulty of determining the appropriate time period by which to discount the disconnection charge. As such, the ICC believes the Commission should move towards a ruling that disconnection costs should be recovered through separate charges to be levied upon the CLEC when the CLEC customer is disconnected. This is a distinct change from the retail pricing methodology experienced in Illinois, as well as the UNE rates approved by the ICC in its *TELRIC Order*. The nature of wholesale and retail markets is different and simply because the practice is allowed in one market does not mean it should be followed in another.

[139] *NPRM,* ¶126

H. Rate Structure

The Commission seeks comments regarding rate structure for local switching and shared transport[140].

The current Commission rules recognize that the unbundled local switching (ULS) network element consists of dedicated and shared facilities: (1) line ports dedicated to single end-users and (2) switching matrix and trunk ports shared by all users of the switch[141]. The Commission has determined that the cost of a dedicated facility should be recovered through a flat charge because a flat charge will ensure that 'a customer will pay the full cost of the facility and no more' and thus 'is most efficient'[142]. The Commission recognizes that the costs of shared facilities, including but not limited to switching matrix and trunk ports, "should be recovered in a manner that efficiently apportions costs among users[143]" and it allows costs of shared facilities of unbundled local switching (*i.e.*, switching matrix and trunk port) to be recovered through either a flat-rated charge or usage-based charge[144].

The Commission seeks comment on "whether, and under what circumstances, changes are needed' to the current FCC rule and regulation governing rate structure for shared facilities of unbundled local switching network element[145]." Argument in support of a flat-rated charge and argument in support of usage-based charge for shared facilities of unbundled local switch network element (*i.e.*, switching matrix and trunk port) have both been advocated by parties and adopted by the ICC.[146]

The most obvious advantage of a flat rate structure is ease of implementation.

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140 *NPRM*, ¶¶131, 132
141 47 C.F.R. §51.319(c); *see also First Report and Order*, ¶ 810
142 *First Report and Order*, ¶744
143 *Id.,* ¶755
144 *Id.,* ¶810

Under a flat-rate structure, cost of switching matrix and cost of trunk ports are uniformly allocated across line ports. Purchasers of unbundled switching elements would pay for switching matrix and trunk port in proportion to the number of line ports purchased. The sum of revenue received from the purchasers of unbundled local switching elements and 'revenue' *received implicitly* from an ILEC itself (for using its own switch elements at forward-looking switch prices) would be exactly equal to the TELRIC plus the allocated shared and common cost[147]. In this sense, there would be no overall over- or under-recovery of costs of shared facilities (or dedicated facilities), and this would be the second advantage of a flat rate structure.

The potential disadvantage of a flat-rated charge for shared switching facility, however, is that it may fail to reflect the cost-causation principle. As the FCC recognizes, "the cost of capacity [of a shared facility] is determined by the volume of traffic that the facilities are able to handle during peak periods"[148]. Cost causation principles require that cost of switching matrix and cost of trunk port be distributed across line ports according to each line port's 'contribution' to the required (or peak-time) capacity of the shared facilities. If, and where, a set of line ports purchased by a carrier "contributes" more than the average to the total required capacity of the shared facility, the ILEC would be under-recover from this carrier — *i.e.*, this carrier would be cross-subsidized. On the other hand, if a set of line ports purchased by a carrier "contribute" less than the average to the total required capacity of the shared facility, the ILEC would be over-recovering the cost

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145 NPRM, ¶¶131-132

146 *TELRIC II Order*, *TELRIC 2000 Order*.

147 "Revenue implicitly received from the ILEC itself" refers to the total dollar amount that the ILEC must pay if it were to purchase the switching network elements from itself at the flat-rated charge.

148 *First Report and Order*, ¶755

of shared facility from this carrier — *i.e.*, this carrier would be cross-subsidizing other carriers. The degree of cross-subsidy depends on the degree of variation in per-port 'contribution' to the total required capacity across carriers that use switching network element.

While cost causation principles require allocating costs of shared facilities based on each line port's contribution to the total required capacity of the shared facility, it would be extremely difficult, if not impossible, to determine precisely each port's contribution. Though usage is not a precise or ideal measurement of each port's contribution to the total required capacity of a shared facility, a high usage port, statistically speaking, also makes a greater contribution to the total capacity. Thus a usage-based rate structure can be used as a substitute or proxy for a contribution-based rate structure to reflect cost causation principles. Usage-based structures can range from Minutes of Usage (MOU)-based to two-tiered usage rate structures, with multi-tiered usage rate structures in the middle. Under the MOU-based rate structure, each carrier pays for the shared switching facility (switching matrix and trunk port) based on the total MOU of the line ports purchased. Under the two-tiered usage rate structure, a carrier pays for a line port based on whether it is a high or low usage port.

A usage-based rate structure has its own disadvantages. The usage-based rate structure may generate a different sort of over- or under-recovery problem, different from the over-/under-recovery problem associated with the flat-rated rate structure. In the case of an MOU-based rate structure, the sum of revenue received from ULS purchasers for the use of the shared switching facility (*i.e.*, switching matrix and trunk port) and "revenue" implicitly received from the ILEC itself for the use of its own shared switching facility (at the forward-looking switch prices) would vary in proportion to the total

network usage. Thus, the total revenue would double if the network usage doubles. Over-recovery would likely occur if an increase in network usage over time were not properly counted for in setting the per-MOU charge.

Moreover, the need for a usage-based approach to reflect cost causation principles is dramatically reduced if the cost of shared switching facilities is a very small percentage of total switch cost. In this case, even the average "contribution" to the total required capacity of shared facilities varies greatly across carriers, the magnitude of cross-subsidy under a flat-rated rate structure may not be sufficient to justify the usage-based approach, considering its complexity in implementation and potential for over- or under-recovery.

Overall, the appropriate rate structure for switching network element varies with the circumstances. The Commission should, while not prohibiting usage-based rate structure to recover the cost of shared switching facility (switching matrix and trunk port), allow state commissions the flexibility to determine the appropriate rate structure for switching matrix and trunk ports in a specific circumstance.

The ICC has addressed issues regarding these items for SBC Illinois in its *TELRIC 2000 Order*[149]. In the *TELRIC 2000 Order*, the ICC acknowledged that the Commission allowed for either flat-rated or measured rates[150]. In the ICC's opinion, UNE rates, if they are to accomplish the Commission's goal of fair recovery and rational price signals, must recover costs in a manner consistent with the way they were incurred.

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[149] *Order,* Illinois Commerce Commission On Its Own Motion v. Illinois Bell Telephone Company: investigation into Tariff Proceeding Providing unbundled Local Switching with Shared Transport, ICC Docket No. 00-0700 (July 12, 2002) (hereafter "*TELRIC 2000 Order*").

[150] *Id.* ¶¶12-15.

I. Rate Deaveraging

The Commission seeks comment on whether, and under what circumstances, it should retain the requirement of geographic deaveraging[151], as well as to retain the requirement to average costs across different classes of service[152]. The ICC believes these requirements will need to be retained in some manner as addressed in the section of the response addressing the impact of the *Triennial Review*.[153]

151 *NPRM*, ¶136
152 *Id.,* ¶ 137
153 See, Section III (B)(1)(b)

IV. RESALE PRICING

The Commission seeks comment regarding resale pricing[154]. The ICC set resale guidelines in June 1996.[155] The ICC believes that these guidelines have served the State of Illinois well, and are fully consistent with the *IUB II Decision*[156]. The ICC addresses certain questions raised in the NPRM in hopes that its experience can benefit the formation of a national policy. The formula used by the ICC to determine wholesale prices for SBC Illinois was developed in Docket 95-0458. It is used to determine a wholesale discount for every service offered by the company and is shown below for possible use by the Commission:

Wholesale Formula

From page 10 of the June 26, 1996 Order in Docket 95-0458/0531 (Consol.):

$$P(w) = TAC(w) + \frac{[P(r) - TAC(r)] * TAC(w)}{TAC(r)}$$

where:

P(w)	=wholesale price,
P(r)	=retail price,
TAC(r)	=retail total assigned cost, and
TAC(w)	=wholesale total assigned cost

By rewriting the equation in the following manner, the method of deriving wholesale rates from retail rates becomes clearer:

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154 NPRM, ¶¶136-141

155 *See, generally*, *Order*, AT&T Communications of Illinois, Inc.: Petition for a total local exchange wholesale service tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company pursuant to Section 13-505.5 of the Illinois Public Utilities Act. LDDS Communications, Inc. d/b/a LDDS Metromedia Communications: Petition for a total wholesale network service tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company pursuant to Section 13-505.5 of the Illinois Public Utilities Act, ICC Dockets No. 95-0458, 95-0531 (consol.); 1996 Ill. PUC LEXIS 320; 172 P.U.R.4th 434 (June 26, 1996) (hereafter "ICC Wholesale Order").

156 Iowa Utilities Bd. v. FCC, 219 F.3d 744; 2000 U.S. App. LEXIS 17234; 21 Comm. Reg. (P & F) 180 (8th Cir. 2000)

$$P(w) = P(r) - [TAC(r) - TAC(w)] - [P(r) - TAC(r)] * [1 - \frac{TAC(w)}{TAC(r)}]$$

The total assigned cost (TAC) is the LRSIC of a service plus administrative and shared costs belonging to a particular group of services. The difference between the retail TAC and the wholesale TAC is the avoided cost for a service. Therefore, it is easily deduced from this second equation that the wholesale price is equal to the retail price minus avoided costs and minus a fraction of the retail contribution. Said another way, the wholesale price allows for the recovery of a pro-rata share of contribution. Further, this formula yields a price ceiling, and SBC Illinois often prices wholesale services below that allowed in the computation.

A. *IUB II* Interpretation of Statutory Guidelines

The ICC is of the opinion that the *IUB II Decision* is clear. We believe that the ICC Wholesale Order is fully consistent with the standard established in *IUB II*. The *ICC Wholesale Order* addressed advertising, maintenance, and uncollectible expenses with respect to SBC Illinois rates for resold services. The *ICC Wholesale Order* denied SBC Illinois recovery of only those costs that that it actually will avoid, rather than those costs that are reasonably avoidable[157]. As such, the ICC is of the opinion that its existing wholesale rate policies do not require modification.

[157] *See, e.g.,* ICC Wholesale Order at 6-62, 67-68, 70, 72 (costs that SBC will actually avoid disallowed, recovery of others permitted)

B. Identification of Avoided Cost Categories

As noted above, the ICC addressed the identification of avoided costs in its *Wholesale Order*. The ICC, while confident that its *Wholesale Order* properly identifies avoided costs, recognizes that adoption of a consistent national policy would give valuable guidance to state commissions, thereby streamlining future state proceedings. The ICC however, urges the Commission, as part of any such national policy, to require that the ILEC bear the burden of proof in showing that such costs would not be avoided, and not simply indicate that certain costs should not be included in whatever avoided cost calculations the ILEC makes.

C. Common Costs

The Commission asks if it would be necessary or helpful for it to identify categories of costs that either are presumptively avoided or presumptively not avoided, and also how common costs should be treated.[158] The ICC's *Wholesale Order* provides for the recovery of a pro-rata share of costs and contribution[159]. The ICC determined the appropriate level of these costs after a showing of these costs by SBC Illinois[160]. The ICC is of the opinion that ILECs should be allowed recovery of wholesale shared and common costs so long as these costs are incurred prudently and would not be avoided.

The Commission also asks if it should establish evidentiary guidelines for determination of the resale discount, such as having carriers specifically identify direct and indirect avoided costs.[161] The ICC notes that any identification of avoided costs, or direction by the FCC on how to determine the specific avoided costs of a carrier, would be a great help in determining the resale discount, because our experience in Illinois is that carriers do not identify avoided costs in a consistent manner.

The Commission concluded in its Local Competition Order that the Subscriber Line Charge ("SLC") should be paid by resellers, but was not subject to the retail discount, and asks in the NPRM if this issue should be revisited.[162] The ICC agrees with the Commission that the Subscriber Line Charge imposed on retail customers should not be subject to the resale discount, and sees no reason why this issue should be revisited

158 *NPRM*, ¶ 144
159 *ICC Wholesale Order* at 35 *et seq*.
160 *ICC Wholesale Order* at 17-20
161 *Id.,* ¶145
162 *Id.,* ¶146

D. Evidentiary Guidelines

In the course of conducting a substantial number of wholesale and UNE rate cases, the ICC has found that cost studies are vital for rate setting purposes. The ICC believes that there is not presently any form of alternative proof that would provide sufficient information for determining proper avoided cost treatment. In addition, the ICC believes that expert testimony or affidavits from ILEC witnesses should accompany such studies. Moreover, the ICC is of the opinion that the more detail that an ILEC provides, the better the case record upon which a state commission decision can be based. The ICC encourages the Commission to require detailed cost studies and identification of costs on a going-forward basis. In making this recommendation, however, the ICC acknowledges that alternative forms of proof may become available, and believes that any rule the Commission adopts should not preclude submission of such evidence.

V. INTERCONNECTION PRICING

See comments under Impact of Triennial Review.[163]

[163] See Section III (B)(1)(b).

VI. IMPLEMENTATION ISSUES

The Commission asks parties to comment on how changes to the Commission's pricing rules should be implemented by the states[164], and whether a national timetable should be established in which UNE cost proceedings would be held to reset all rates.[165] UNE rates are set in Illinois first through interconnection agreements, either negotiated or arbitrated. However, state law also requires that a tariff must be filed before a carrier can provide a service, and therefore the ICC also requires UNE rates to be tariffed[166].

In Illinois, UNEs are non-competitive services as defined by statute[167], and therefore are subject to suspension and investigation when the ICC determines that this is warranted[168], so when an ILEC files a UNE tariff, the normal consequence is to suspend the tariff pending a full investigation. Illinois statute provides eleven months, and no more, for suspension and investigation of a non-competitive tariff filed by a telecommunications carrier[169]. In some cases, however, the ICC has initiated proceedings to determine rates for UNEs without the ILEC having filed a tariff[170]. When this occurs, there is no statutory time limit for completing the docketed proceeding, and all parties in the case are allowed adequate time for discovery, testimony, and briefs so that all their arguments can be heard. Also, the intervening parties do not have the data of the ILEC, so they require sufficient time to acquire and analyze the data, and this activity, in addition to the testimony, hearings, and briefing of the matter by the parties, may take considerably longer than the eleven months permitted in the case of a suspended tariff.

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164 *Id.,* ¶149

165 *Id.,* ¶150

166 220 ILCS 5/9-102, 9-201

167 See 220 ILCS 5/13-502 (Telecommunications services must be classified as competitive or non-competitive, and are regulated differently based upon that classification)

168 220 ILCS 5/9-201(b)

169 *Id*. It should be noted that, if the ICC cannot complete its investigation within the prescribed eleven-month period, the tariff goes into effect, although the ICC can thereafter order it to be altered.

For these reasons, the ICC does not believe that a 9-month time period is sufficient to establish new UNE rates. Current rates for some ILECs have been in effect for over 5 years, and although we agree that it is time to reevaluate the current rates, we should allot a proper amount of time to complete proceedings.

[170] *See TELRIC Order*, *TELRIC II Order*.

VII. SUMMARY OF RECOMMENDATIONS

The ICC appreciates this opportunity to comment before the Commission. The following is a summary of our recommendations discussed in detail above.

1. The TELRIC methodology should largely be retained. However, there may need to be some adjustments to the methodology so that the network costs being developed are more realistic, and less hypothetical.
2. The Commission's pricing goals should be upheld. A primary goal of UNE pricing should be to set efficient entry and investment signals.
3. The Commission should not use historical costs to judge the reasonableness of forward-looking costs, since historical costs were incurred through the purchase of past technologies and network designs rather than forward-looking technologies and designs.
4. Allowing the recovery of the entire cost of the more efficient technology best comports with the Commission's original TELRIC pricing methodology.
5. The Commission should clarify that forward-looking UNE rates are to recover only those forward-looking costs associated with providing features, functions, and capabilities that the ILEC is providing through its existing network elements and that recovery shall not include costs associated with providing features, functions, and capabilities that the ILEC does not provide through its existing UNEs.
6. The Commission should permit recovery for all features, functions, and capabilities that the ILEC currently provides to the CLEC over the ILEC's existing technology, whether or not the CLEC takes advantage of all such features, functions, or capabilities offered.

7. When developing guidelines pertaining to rate changes over time, the Commission should take into account that if the ILECs are no longer required to provide UNEs in a portion of a UNE zone, the UNE rates will no longer be reflective of the costs of providing UNEs in remaining portions of UNE zones. The ICC recommends that overhead expenses be limited to those that relate only to the UNE, or wholesale, part of the business.
8. Rules regarding the allocation of common, or, for preference, shared and common costs should be explicit, as such costs can become a large driver of UNE rates. If shared and common costs cannot be directly assigned, they should be allocated based on a ratio of related retail expense to the related wholesale expense.
9. The existing rules could be enhanced by expressly prohibiting any cost models that identify a "wholesale" or "retail" network that is purportedly separate from the ILEC's entire network
10. The company specific models, rather than generic models, for developing UNE rates should be retained.
11. The existing rules, which allow for a network design that incorporates existing wire centers and existing customer locations, are reasonable and should be maintained. They reduce litigation of network design issues in proceedings for determining UNE rates.
12. The Commission should clarify in its rules that forward-looking technology be modeled only to the extent that it provides a least-cost means of provisioning services.
13. Planned network upgrades should not be used for pricing UNEs. Rather, the current long-range UNE methodology represents the most reasonable approach.

14. Changing network assumptions by using actual fill factors and accelerated depreciation should not be undertaken because higher UNE rates will likely result.
15. The FCC should establish rules for transparency and verifiability (auditable).
16. If the Commission wishes to release guidelines on network design assumptions, it should do so by acknowledging that there is a range of appropriate network assumptions, depending on population densities, geography, and other factors.
17. The Commission should continue its use of TELRIC as approved by the federal courts, but inputs for determining costs should be combined in a way to reflect the current network at what it would cost the ILEC to replace it, or a CLEC to replicate it.
18. The FCC should be mindful of state legal obligations imposed upon state commissions in this arena. The ICC, for example, has been ordered by the General Assembly to use the following when determining depreciation costs. "the [Illinois Commerce] Commission shall employ depreciation rates that are forward-looking and based on economic lives as reflected in the incumbent local exchange carrier's books of accounts as reported to the investment community under the regulations of the Securities and Exchange Commission. Use of an accelerated depreciation mechanism shall be required in all cases." Accommodations should be made for such state level determinations.
19. The Commission should adopt rules requiring time-consistency in the development of forward-looking switch costs.
20. Forward-looking switch prices should be based on Total Element Long Run Incremental Cost. Given that it is a long-run concept, as defined by federal law

(*see* 47 C.F.R 51.505(b)), it would be more appropriate to apply the dynamic long run equilibrium discount mix in setting forward-looking switch prices.

21. A single weighted average cost of capital should be used for all of a given ILEC's UNEs. That cost of capital should reflect a level of competitive risk consistent with that implied by the operating cost assumptions the FCC chooses.

22. If the Commission decides to allow ILECs to accelerate depreciation, and charge higher TELRIC rates when assets are first purchased, then there should be some built-in mechanism in TELRIC to lower rates as depreciation expenses are lowered (after initial depreciation expense is recorded in the early life of an asset).

23. Depreciation rates for UNE pricing purposes should be developed based on the goals of the UNE process: i.e., lower prices for competitive purposes or higher prices to increase revenue streams to the ILEC.

24. Forward-looking methodology should be used to determine long run incremental costs and therefore UNE pricing and that methodology could include some real-world attributes of the current network.

25. As the cost of entry into a market increases, the ability of competitors to enter a market decreases. As such, common costs should only be recovered via recurring charges.

26. The Commission should rule that disconnection costs should be recovered through separate charges to be levied upon the CLEC when the CLEC customer is disconnected.

27. The FCC should not tamper with existing wholesale rate policies in states where the state regulatory commission determines that those policies do not require modification, such as in Illinois.

28. The Commission should require detailed cost studies and identification of costs on a going-forward basis.

29. Non-recurring charges and joint and common cost allocations should not include costs that may be duplicated in retail rates. The rate structure for UNEs should be separate from the retail rate structure, that is, there should be an allocation between retail and wholesale, not two separate structures. Rate deaveraging may need to be addressed because of UNE offerings being different between enterprise and mass market customers, and the frequency of UNE rate changes over time should be based on either a specific time frame, or using a formula-based calculation such as the ICC uses for alternative regulation companies.

30. The Commission should require transparency and verifiability in an ILEC's cost models. The ICC does not develop its own cost models, but depends on models provided primarily by ILECs to determine costs, therefore transparency and verifiability are essential aspects of cost models.

31. The FCC should allow adequate time to all parties when UNE rates are set under formal rate proceedings.

VIII. CONCLUSION

WHEREFORE, for each and all of the foregoing reasons, the ICC respectfully requests that the Commission consider these comments and recommendations in issuing a final rule in this proceeding and provide any and all appropriate relief.

Respectfully submitted,

ILLINOIS COMMERCE COMMISSION

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